Supreme Court, U.S.
FILED

981106 JAN 1 1 1999

OFFICE OF THE CLERK

No. ____

IN THE

Supreme Court of the United States

October Term, 1998

ACM PARTNERSHIP
SOUTHAMPTON-HAMILTON COMPANY,
TAX MATTERS PARTNER,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition for a Writ of Certiorari
To the United States Court of Appeals
For the Third Circuit

PETITION FOR A WRIT OF CERTIORARI

WILLIAM L. GOLDMAN
CHRISTOPHER KLIEFOTH
MCDERMOTT, WILL & EMERY
600 Thirteenth Street, N.W.
Washington, D.C. 20005
(202) 756-8000

ALBERT H. TURKUS
Counsel of Record
FRED T. GOLDBERG, JR.
PAMELA F. OLSON
SKADDEN, ARPS, SLATE,
MEAGHER & FLOM LLP
1440 New York Avenue, N.W.
Washington, D.C. 20005
(202) 371-7000

Attorneys for Petitioner ACM Partnership

Balmar Legal Publishing Services, Washington, D.C. (202) 682-9800

QUESTION PRESENTED

Whether a federal court may refuse to apply the federal income tax statutes and regulations that would otherwise govern a transaction on the ground that the taxpayer failed to satisfy a judicially created test, not anchored in any provision of the statutes or regulations, requiring an appreciable "non-tax economic effect" or a "subjective non-tax purpose."

PARTIES TO THE PROCEEDINGS

Petitioner, ACM Partnership ("ACM") is an affiliate of a publicly owned corporation, Colgate-Palmolive Company ("Colgate"). Southampton-Hamilton Company, Tax Matters Partner of ACM, is a subsidiary of Colgate. There are publicly owned corporations, not parties to the proceeding, that have a financial interest in the outcome: (1) Colgate is a partner in ACM; (2) Merrill Lynch MLCS, Inc., also a partner in ACM, is a subsidiary of Merrill Lynch & Co.; (3) Algemene Bank Nederland N.V. ("ABN"), a Netherlands company, managed the affairs of Kannex Corporation N.V., a Netherlands Antilles entity, which was a partner in ACM. ABN does not have a financial interest in the outcome of this proceeding. Respondent is Commissioner of Internal Revenue.

TABLE OF CONTENTS

OPINIONS BELOW 3

JURISDICTION 3

STATUTORY PROVISIONS INVOLVED 3

STATEMENT 4

ACM's Ownership and Sales of the Citicorp Notes 4

ACM's Tax Reporting 5

The Commissioner's Selective Application of the Governing Statutes and Regulations 8

Tax Court Review 9

Third Circuit Review 10

REASONS FOR GRANTING THE PETITION 14

I. THE THIRD CIRCUIT'S DECISION CONFLICTS WITH THIS COURT'S DECISION IN *COTTAGE SAVINGS* AND MISAPPLIES THE DECISION IN *GREGORY* 15

A. The Third Circuit's decision conflicts with *Cottage Savings* 15

B. *Gregory* does not grant the courts license to apply a test ungrounded in the language of the governing statutes 17

II. THIS CASE PRESENTS QUESTIONS OF COMPELLING IMPORTANCE TO THE ADMINISTRATION OF THE FEDERAL TAX LAWS 20

A. The Third Circuit's decision undermines the balance between the three branches of government required by this Court's decision in *Chevron* 20

B. The Third Circuit effectively granted the Commissioner equitable relief from his own regulation 22

C. The Third Circuit's decision will needlessly entangle the judiciary in myriad disputes over the application of standards that cannot be applied in a principled and even-handed way 24

CONCLUSION 25

TABLE OF AUTHORITIES

Cases	Page(s)
ASA Investerings Partnership v. Commissioner, 76 T.C.M. (CCH) 325 (1998)	8, 23
Arkansas Best Corp. v. Commissioner, 485 U.S. 212 (1988)	18
Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837 (1984)	3, 15, 20, 21
Cottage Savings Association v. Commissioner, 499 U.S. 554 (1991)	*passim*
Cottage Savings Association v. Commissioner, 890 F.2d 848 (6th Cir. 1989)	16
Cottage Savings Association v. Commissioner, 90 T.C. 372 (1988)	16
Estate of Delaune v. Commissioner, 143 F.3d 995 (5th Cir. 1998)	21
Fabreeka Products Co. v. Commissioner, 294 F.2d 876 (1st Cir. 1961)	19, 20, 22
Gregory v. Helvering, 293 U.S. 465 (1935)	*passim*
Hanover Bank v. Commissioner, 369 U.S. 672 (1962)	22
Horn v. Commissioner, 968 F.2d 1229 (D.C. Cir. 1992)	20
Knetsch v. United States, 364 U.S. 361 (1960)	18
Lewyt Corp. v. Commissioner, 349 U.S. 237 (1955)	23
Maysteel Products, Inc. v. Commissioner, 287 F.2d 429 (7th Cir. 1961)	20
Mutual Savings Life Insurance Co. v. United States, 488 F.2d 1142 (5th Cir. 1974)	21
Pacific National Bank of Seattle v. Commissioner, 91 F.2d 103 (9th Cir. 1937)	21
United States v. Brockamp, 117 S. Ct. 849 (1997)	22, 23
United States v. Correll, 389 U.S. 299 (1967)	21, 22

Statutes **Page(s)**

I.R.C. § 163 18
I.R.C. § 453 ..... *passim*
I.R.C. § 1001 ..... *passim*
I.R.C. § 6511 23
28 U.S.C. § 1254(1) 3

Regulations

Temp. Treas. Reg. § 15a.453-1(c)(3) ..... *passim*
Temp. Treas. Reg. § 15a.453-1(c)(7) 6
Treas. Reg. § 1.1001-1(d) 5

Other Authorities

S. Rep. No. 96-1000 (1980), *reprinted in* 1980 U.S.C.C.A.N. 4696 6

No. ____

IN THE

Supreme Court of the United States

October Term, 1998

ACM PARTNERSHIP
SOUTHAMPTON-HAMILTON COMPANY,
TAX MATTERS PARTNER,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition for a Writ of Certiorari
To the United States Court of Appeals
For the Third Circuit

PETITION FOR A WRIT OF CERTIORARI

At issue in this case is the authority of the judiciary to overturn the result produced by the federal tax statutes enacted by Congress and the regulations promulgated by the Treasury Department when the courts dislike the outcome those rules require. In the decision below, the Third Circuit refused to apply the tax rules governing certain sales transactions of petitioner ACM Partnership ("ACM") because those rules reduced federal income tax liability. Instead, the court embarked on a result-oriented analytical journey, using a judicially crafted test wholly unrelated to the governing statutes or regulations, to prohibit the application of those provisions.

If the relevant tax statutes and regulations — namely, Internal Revenue Code §§ 1001 and 453, and the Treasury

Regulations promulgated under § 453 — were applied to the transactions, it is undisputed that ACM correctly reported its income and loss for tax purposes. Indeed, the Third Circuit acknowledged that ACM's sale transactions "satisfied each requirement of the contingent installment sale provisions and ratable basis recovery rule" of § 453 and the regulations thereunder. (App. at 31a). However, the Third Circuit refused to apply the rules governing the reporting of the transactions because the operation of those rules reduced the federal income tax liability of ACM's partners, a result the court found distasteful. The court held that the tax treatment dictated by §§ 1001 and 453 and the regulations under § 453 is available only if the transaction can first clear a judicially devised hurdle — one that appears nowhere in the relevant provisions of the Internal Revenue Code or the Treasury Regulations — requiring an appreciable "non-tax economic effect" or a "subjective non-tax purpose" for engaging in the transaction. Finding that ACM's transactions did not satisfy that test, the Third Circuit refused to recognize the transactions as sales or exchanges for purposes of §§ 1001 and 453. In essence, what the Third Circuit did was to grant equitable relief to the Commissioner of Internal Revenue ("Commissioner") from the results dictated by the application of the relevant statutory provisions and his own regulations.

The imposition of this extrastatutory obstacle to the application of §§ 1001 and 453 conflicts directly with the holding in *Cottage Savings Ass'n v. Commissioner*, 499 U.S. 554 (1991), in which this Court held that a transaction motivated only by the generation of tax losses and that did not substantially affect the economic position of the taxpayer must nonetheless be recognized as a "sale or exchange" within the meaning of § 1001. Furthermore, the opinion below misapplies this Court's directive in *Gregory v. Helvering*, 293 U.S. 465 (1935), that the Commissioner and the courts should ignore a taxpayer's tax motives and instead focus on whether particular statutory requirements have been satisfied. The opinion of the Third Circuit also presents compelling issues of tax administration because it upsets the

carefully crafted balance of power set forth in *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984), by allowing the Commissioner to apply to the courts for a kind of equitable license to disavow the applicable statutes and his own regulations when they are used by a taxpayer to reduce tax liability and because it will require the judiciary to make visceral and standardless determinations regarding whether a taxpayer's transactions should be respected for tax purposes, thus undermining predictability and neutrality. Thus, the decision below marks an important shift in both the substance of the tax law and in the judiciary's role in tax cases, significant changes that merit review by this Court.

OPINIONS BELOW

The opinion of the United States Court of Appeals (App. at 1a-72a) is reported at 157 F.3d 231 (3d Cir. 1998). The opinion of the United States Tax Court (App. at 1b-105b) is reported at 73 T.C.M. (CCH) 2189 (1997).

JURISDICTION

The judgment below was entered on October 13, 1998. The jurisdiction of this Court rests on 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

The relevant portions of §§ 453 and 1001 of the Internal Revenue Code of 1986, as amended, 26 U.S.C. §§ 453 and 1001, and the Treasury Regulations accompanying § 453 are set forth in the Appendix at 1c-6c.[1]

---

[1] Unless stated otherwise, all section references, cited as "§ __", are to the Internal Revenue Code of 1986, as amended (the "Code"), which is set forth in Title 26 of the United States Code.

STATEMENT

ACM's Ownership and Sales of the Citicorp Notes

In late October 1989, Southampton-Hamilton Company ("Southampton"), Merrill Lynch MLCS Inc. ("MLCS"), and Kannex Corporation N.V. ("Kannex") formed ACM as a partnership. Southampton was a wholly-owned subsidiary of Colgate-Palmolive Company ("Colgate"). MLCS was a wholly-owned subsidiary of Merrill Lynch Capital Services, an affiliate of Merrill Lynch and Co., Inc. Kannex was a Netherlands Antilles corporation controlled by an affiliate of the Dutch bank, Algemene Bank Nederland N.V. ("ABN"). Southampton and MLCS were subject to U.S. taxation; Kannex was not. (App. at 3a-4a).

In early November 1989, the three partners contributed $205 million to ACM. ACM placed the cash in a bank account and, the next day, used it to purchase $205 million principal amount of debt instruments (the "Citicorp Notes") from Citicorp, an unrelated party. (App. at 17a). During the period ACM owned the Citicorp Notes, they generated interest income that ACM reported as taxable income on its federal income tax returns.[2] Third Circuit Joint Appendix ("3d Cir. J.A.") at 108, 144-225, 454-94. In addition, ACM bore the risk that Citicorp Notes would decline in value because of reduction in Citicorp's credit rating or that Citicorp would default on its obligations under the Notes. (App. at 78b, 102b-103b; 3d Cir. J.A. at 955, 958, 1074, 2492-93, 2870-71, 2902-04).

In late November, ACM sold Citicorp Notes with an aggregate principal amount of $175 million to other unrelated parties.[3] In exchange, ACM received $140 million in cash (which it used to purchase Colgate debt instruments) and

---

[2] ACM earned approximately $1.2 million of interest income on the Citcorp Notes during November 1989. (3d Cir. J.A. at 108).

[3] ACM held the remainder of the Citicorp Notes for two years, earning $4.3 million of interest on those Notes. (App. at 21a-22a).

obligations to make twenty quarterly payments based on a floating interest rate times a stated notional amount.[4] The instruments recording these obligations are called the "LIBOR Notes" because the interest rate specified was the three-month London Interbank Offering Rate (LIBOR). (App. at 19a-20a).

ACM's Tax Reporting

ACM reported the sales of the Citicorp Notes in accordance with the applicable provisions of the Internal Revenue Code — namely, §§ 1001 and 453 — and the Treasury Regulations promulgated pursuant to § 453. (App. at 22a-23a). Section 1001 requires taxpayers to recognize — *i.e.*, take into account in calculating taxable income — gain or loss on all sales or exchanges of property, absent exceptions not relevant here. § 1001(c). Section 453 governs the tax accounting for all installment sales, which are sales involving a purchase price paid over a period of more than one taxable year. § 453(b)(1). *See also* Treas. Reg. § 1.1001-1(d).

Because the LIBOR Notes obligated their issuers to make payments of amounts contingent on fluctuations in LIBOR over a fixed period of several years, the payment period, but not the maximum sales price of the Citicorp Notes, was ascertainable in the year of sale. Thus, the sales were "contingent payment installment" sales, and their tax treatment was governed by Temp. Treas. Reg. § 15a.453-1(c). (App. at 22a-23a). That regulation requires that:

> When a stated maximum selling price cannot be determined as of the close of the taxable year in which the sale or other disposition occurs, but the maximum period over which payments may be received under the contingent sale price agreement

---

[4] These obligations were "notional principal contracts," meaning that a principal amount was stated for purposes of setting the size of the periodic payments. Only the twenty periodic payments were called for; no principal payment was due at maturity.

> is fixed, the taxpayer's basis (inclusive of selling expenses) shall be allocated to the taxable years in which payment may be received under the agreement in equal annual increments.

Temp. Treas. Reg. § 15a.453-1(c)(3). Thus, under the regulation, ACM's tax basis in the Citicorp Notes sold — roughly equal to ACM's cost for those Notes — was to be allocated evenly to each of the years in the entire payment period, including the year of the cash payments and the years in which LIBOR payments were to be made. This regulatory requirement to allocate basis equally over the payment period is known as the "ratable basis recovery rule." (App. at 22a-23a).

Temporary Treasury Regulation § 15a.453-1(c) is a legislative regulation, promulgated by the Secretary of the Treasury in response to an explicit statutory directive to provide by regulation "for ratable basis recovery in transactions where the . . . total contract price . . . cannot readily be ascertained." § 453(j)(2). In promulgating this regulation, the Secretary expressly recognized that the ratable basis recovery rule could "substantially and inappropriately defer or accelerate recovery" of basis and thus lead to a potential "distortion" in the reporting of taxable income, because the rule requires allocating equal amounts of basis to years for which there is no assurance that payment amounts would be equal. Temp. Treas. Reg. § 15a.453-1(c)(7). (Congress recognized that ratable basis recovery could result in a distortion of annual income. *See* S. Rep. No. 96-1000 at 24 & n.31 (1980).) The regulation gives the Commissioner an asymmetrical power to correct for such distortion, authorizing him to require another method of accounting when gain is inappropriately deferred, but not when gain is accelerated, as it was in ACM's case. Temp. Treas. Reg. § 15a.453-1(c)(7).[5]

---

[5] Under the regulation, taxpayers may request an alternative method of accounting when gain is accelerated.

ACM's gain or loss in each year on the sales of the Citicorp Notes was measured as the *difference between the* amount received in that year from the buyers and the basis allocated to that year pursuant to the ratable basis recovery rule. Because most of the consideration for the Notes was received as cash in the year of the sale, and because the ratable basis recovery rule required an allocation of basis equally over the entire payment period, ACM reported a large taxable gain in the year of the sale and a large tax loss in a later year.[6] (App. at 23a, 26a). This substantial acceleration of income was precisely the result anticipated and compelled by the Treasury Regulations.

During the period in which ACM received payments on the LIBOR Notes, the partners' relative ownership interests in ACM changed, so that Kannex's partnership interest, originally 82.63 percent, was eventually eliminated through purchase by Southampton and Colgate and redemption by ACM. As a consequence of the redemption, Southampton's, Colgate's, and MLCS's relative partnership interests increased. (App. at 17a, 21a-22a). Because each partner was allocated a share of ACM's taxable gain and loss in each year in accordance with its respective partnership interest, the result of these changing interests was that Kannex was allocated most of the taxable gain arising from the application of the ratable basis recovery rule and Southampton and Colgate were allocated most of the loss. (App. at 23a-24a, 26a-27a). Because Kannex, as a foreign corporation, was not subject to U.S. taxation, it did not pay federal income tax on its allocated share of the gain. (App. at 23a).

---

[6] In addition to the gain and loss resulting from the application of the ratable basis recovery rule, ACM also reported tax losses attributable to economic losses incurred when ACM's LIBOR Notes dropped in value due to a change in market conditions (*i.e.*, a decline in interest rates). The Third Circuit determined that ACM was entitled to losses incurred other than from the application of the ratable basis recovery rule. (App. at 62a-67a).

The Commissioner's Selective Application of the Governing Statutes and Regulations

ACM's contingent payment installment sales yielded a tax result under the ratable basis recovery rule perhaps not anticipated by the Secretary when he promulgated Temp. Treas. Reg. § 15a.453-1(c). That is, although the recognition of income by ACM was indeed accelerated into the first part of the installment sale reporting period, as expressly contemplated by the Commissioner's regulations, this "distortion" did not produce the increased federal tax revenues that might be expected to accompany accelerated taxable gain because most of that gain was allocated to Kannex, a nontaxable entity, as the partner with the largest interest. The Commissioner deemed this result inappropriate and therefore issued ACM a notice of Final Partnership Administrative Adjustment ("FPAA") setting forth several alternative grounds on which ACM should be denied the tax treatment required by law. (App. at 4b; 3d Cir, J.A. at 39-40).

As the FPAA makes clear, the Commissioner's willingness to apply the governing provisions, and therefore respect ACM's transactions, depended solely on whether the taxable gain would be imputed to an entity subject to U.S. taxation. Thus, under one scenario, the Commissioner argued that the non-U.S. entity, Kannex, was not a partner or was not properly allocated income from the sale transaction. In that case, only ACM partners taxable in the U.S. were allocated income or loss by the ACM Partnership. Because that scenario resulted in accelerated tax revenue, the Commissioner readily applied § 1001, § 453, and Temp. Treas. Reg. § 15a.453-1(c), and respected the substance of ACM's contingent payment installment sale transactions.[7] (3d Cir. J.A. at 39). But if Kannex's partnership interest were to

---

[7] This is exactly the result reached in another Tax Court case involving a similar transaction. *See ASA Investerings Partnership v. Commissioner*, 76 T.C.M. (CCH) 325 (1998), and the decision in that case entered on December 3, 1998.

be respected and allocated its proportionate share of the gain, the Commissioner refused to apply the governing statutes and regulations on the ground that ACM's transactions were:

> devoid of economic substance necessary for recognition for Federal income tax purposes and were totally lacking in economic reality. The transactions were created solely for tax motivated purposes without any realistic expectation of profit.

(App. at 27a; 3d Cir. J.A. at 39). Under this alternative, the Commissioner adjusted ACM's tax reporting to eliminate both the gain and the loss attributable to the application of the ratable basis recovery rule, effectively disregarding ACM's contingent payment installment sales. (3d Cir. J.A. at 40).

Under no alternative did the Commissioner make an adjustment to remove from ACM's taxable income the interest earned on the Citicorp Notes or the LIBOR Notes. Thus, under each of the alternatives, the Commissioner recognized ACM's ownership of both the Citicorp Notes and the LIBOR Notes. In the first instance, where there was an acceleration of tax revenue, the Commissioner also recognized the sales in which ACM exchanged ownership of cash and LIBOR Notes for its ownership of the Citicorp Notes; in the second instance, the Commissioner argued that the very same sales should be disregarded. (3d Cir. J.A. at 28-42).

Tax Court Review

The Tax Court upheld the Commissioner's adjustments under the second alternative described above, disregarding the installment sale transactions and applying instead an overarching "economic substance" test ungrounded in the Internal Revenue Code or the Treasury Regulations. The test applied by the Tax Court was different from that asserted by the Commissioner. The court declared that "transactions will only be recognized for tax purposes if there is some 'tax-independent purpose' for the entire transaction." (App. at 71b-72b). Under the Tax Court's extrastatutory test, "the

transaction must be rationally related to a useful nontax purpose" and the court must consider "[b]oth the utility of the stated purpose and the rationality of the means chosen to effectuate it." (App. at 72b). The court noted that "[a] rational relationship between purpose and means ordinarily will not be found unless there was a reasonable expectation that the nontax benefits would be at least commensurate with the transaction costs." (App. at 72b).

In applying its test, the Tax Court concluded that Colgate did not have a reasonable prospect for profit from ACM's transactions and that there was no other tax-independent purpose for the transactions. The Tax Court therefore refused to accept ACM's ownership and sales of the Citicorp Notes for installment sale purposes, but did treat ACM as the owner of the Citicorp Notes for purpose of including in ACM's taxable income the interest earned on the Notes.

Third Circuit Review

A divided panel of the Third Circuit affirmed in relevant part. The majority concluded that the contingent payment installment sales "satisfied each requirement" of the relevant provisions of § 453 and its accompanying regulations. (App. at 31a). Like the Tax Court, however, the Third Circuit majority refused to tax ACM's transactions in accordance with the governing statutes and regulations, but it used yet a third extrastatutory test to evaluate ACM's transactions.

While acknowledging in a footnote that tax-savings motivations do not invalidate transactions,[8] the court examined whether there was a "subjective business motivation" for the transactions and asserted that "the intended purposes behind a transaction are relevant in assessing its economic substance even where the statute is

---

[8] *See* App. at 34a n.31 ("[W]here a transaction objectively affects the taxpayer's net economic position, legal relations, or non-tax business interests, it will not be disregarded merely because it was motivated by tax considerations").

drafted in broad terms that do not require a particular intent or purpose." (App. at 33a, 47a n.44). In addition, the court scrutinized ACM's transactions for sufficient "objective economic consequences," again without any predicate in the governing statutes or regulations. The court asserted that, although these two elements were not "discrete prongs of a 'rigid two-step analysis'," transactions failing both aspects of the test will not be respected for tax purposes. (App. at 34a).

Despite the clear import of this Court's decisions in *Cottage Savings* and *Gregory*, the court rejected ACM's argument that it was improper to apply such an extrastatutory test as a rationale for prohibiting the application of the governing Code provisions and regulations. The court first concluded that ACM's ownership and sales of the Citicorp Notes should not be respected because they "had only nominal, incidental effects on ACM's net economic position" so there was no disposition of assets to which §§ 1001 and 453 should be applied. (App. at 39a). The Third Circuit acknowledged that ACM purchased the Citicorp Notes and received interest income from the Notes (which ACM reported as taxable income), and the Tax Court had stated that ACM's investment in the Citicorp Notes "did subject the partnership to risk." (App. at 17a, 102b-103b). The Third Circuit majority nonetheless rejected the notion that ACM "had acquired the benefits and burdens associated with the Citicorp [N]otes in an economically substantive sense" (App. at 43a n.39), concluding that ACM's ownership and sales of the Citicorp Notes were "fleeting and economically inconsequential" and therefore had no material economic effect. (App. at 39a, 43a).

The court based this conclusion on its speculation that there was little or no chance the Citicorp Notes would change in value during the period that ACM owned the Notes and on its judgment that the interest income paid by Citicorp on the Notes accrued at only a slightly higher rate than that paid on ACM's bank deposits of the partners' cash contributions before such deposits were used to purchase the Notes. (App.

at 37a).[9] The court did not suggest that anyone other than ACM owned the Notes during the 24-day period. Nor did it address the fact that both the Commissioner and the Tax Court respected ACM's ownership of the Citicorp Notes for purposes of including in ACM's taxable income the $1.2 million of interest income generated by the Notes during November, 1989.

The majority then stated that:

> Where ... objective economic effects are lacking, scrutiny of the subjective intent behind the transactions becomes an important means of determining whether the transactions constitute a scheme with "no purpose other than tax avoidance" that may not give rise to deductible losses even where the statute contains no express requirement that the transaction serve a non-tax business purpose.

(App. at 47a-48a n. 44) (citation omitted). Applying this test, the court concluded that ACM's transactions were not intended to serve a nontax purpose and were not reasonably expected to generate a pre-tax profit. (App. at 48a-62a).

Despite the fact that it refused to recognize ACM's ownership and sales of the Citicorp Notes, the court did recognize the fruits of those sales — ACM's ownership and sales of the LIBOR Notes. The court concluded that the ownership and sales of the LIBOR Notes constituted a

---

[9] Although the Third Circuit suggested that the risk of a significant decline in the value of the Citicorp Notes was not appreciable, the possibility of such a decline due to a significant drop in Citicorp's credit status — and even the possible failure of such a major financial institution — was recently illustrated once again by the troubles of the major hedge fund Long Term Capital Management, Inc. Even the Tax Court acknowledged that "[t]here was a significant risk that Citicorp's credit could deteriorate," and noted that data for the relevant period showed "many instances in which the credit spread on publicly traded Citicorp debt declined by large amounts over short periods of time." (App. at 78b).

"separable, economically substantive" element of ACM's activities and that ACM was entitled to recognize a loss equal to the decline in value of the LIBOR Notes during the period ACM owned them. (App. at 66a).

Judge McKee dissented. He objected to the majority's interposition of an extrastatutory obstacle to the application of the relevant statutes and regulations:

> By finding that ACM's sales of the Citicorp notes for cash and LIBOR Notes "satisfied each requirement of the contingent installment sales provisions and the ratable basis recovery rule,". . . yet, simultaneously subjecting these transactions to an economic substance and sham transaction analysis, the majority has ignored the plain language of IRC § 1001, and controlling Supreme Court precedent. We have injected the "economic substance" analysis into an inquiry where it does not belong.

(App. at 67a). Judge McKee noted that ACM's sales of the Citicorp Notes "were clearly 'legitimate' sales in the nontax sense" and that, under this Court's opinion in *Cottage Savings*, "the tax loss here should have been allowed." (App. at 69a-70a).

Judge McKee also objected to the majority's test on the ground that it entails a subjective result-oriented inquiry that is incompatible with the role of the federal judiciary:

> I can't help but suspect that the majority's conclusion . . . is, in its essence, something akin to a "smell test." If the scheme in question smells bad, the intent to avoid taxes defines the result as we do not want the taxpayer to "put one over." However, the issue clearly is not whether ACM put one over on the Commissioner, or used LIBOR notes to "pull the wool over his eyes." The issue is whether what ACM did qualifies for the tax treatment it seeks under § 1001. The fact that ACM may have "put one over" in crafting these transactions ought not to influence

> our inquiry. Our inquiry is cerebral, not visceral. To the extent that the Commissioner is offended by these transactions he should address Congress and/or the rulemaking process, and not the courts.

(App. at 71a-72a).

REASONS FOR GRANTING THE PETITION

The federal income tax system is a code-based regime. Congress enacts the law, the Secretary of the Treasury (the "Secretary") promulgates regulations pursuant to his statutory grant of authority to expand on or interpret the law, and the taxes collected are determined by reference to those laws and regulations. This code-based regime is designed to provide guidance, to taxpayers and the Commissioner alike, that is predictable in result and neutral in application. Predictability and neutrality are imperiled, however, by the *ad hoc* imposition of judicially created prerequisites to the application of the governing statutory and regulatory rules. Judicial application of extrastatutory tests, such as the Third Circuit's appreciable "non-tax economic effect" and "subjective non-tax purpose" requirements, improperly departs, without congressional or regulatory sanction, from the statutes and regulations written to govern taxpayers' transactions.

The multifaceted and factual test applied by the Third Circuit, ungrounded as it is in any statutory or regulatory provision, is bound to be elastic in application and unpredictable in result. This Court has not imposed such a test as a gatekeeper to the application of the Internal Revenue Code. Indeed, the Third Circuit's opinion conflicts with this Court's decision in *Cottage Savings*, in which the Court applied § 1001 without first requiring the taxpayer to demonstrate an appreciable nontax economic effect or nontax purpose for the transaction. The opinion below also reflects a corruption of this Court's opinion in *Gregory*, which holds that tax avoidance motives are irrelevant and requires, far from any sort of extrastatutory test, an inquiry that is grounded only in the language of the relevant statutes.

It is of widespread importance to taxpayers and to the sound administration of the federal tax laws that this Court grant plenary review to rectify the Third Circuit's departure from *Cottage Savings* and misapplication of *Gregory*. Such an action is critical to the preservation of the predictability and neutrality that are essential to our code-based tax system and to the principle, articulated in *Chevron*, that courts should hesitate to interfere in the province of rulemakers. Rather than seeking equitable relief from the courts, the Commissioner should seek a change in the Treasury Regulations or statutes that yield the result with which he is dissatisfied.

I. THE THIRD CIRCUIT'S DECISION CONFLICTS WITH THIS COURT'S DECISION IN *COTTAGE SAVINGS* AND MISAPPLIES THE DECISION IN *GREGORY*.

A. The Third Circuit's decision conflicts with *Cottage Savings*.

The Third Circuit declined to recognize ACM's ownership and sales of the Citicorp Notes as "sales or exchanges" within the meaning of § 1001 because, in the majority's view, the transactions lacked an appreciable "non-tax economic effect" and ACM lacked a "subjective non-tax purpose" for owning and selling the Notes. That holding is directly contrary to this Court's decision in *Cottage Savings Ass'n v. Commissioner*, 499 U.S. 554 (1991), which held that a sale or exchange was to be respected for purposes of § 1001 even where the motivation for and economic result of the transaction was to reduce tax liability.

Cottage Savings, a savings and loan association, owned hundreds of fixed-rate residential mortgages that had declined in value as interest rates rose. It exchanged participations (or interests) in that pool of mortgages with another savings and loan association that owned another pool of mortgages of equal value, interest rates, and maturity. Even though the mortgages exchanged were of equal value, the taxpayer

reported a substantial taxable loss under § 1001 because the value of the new pool was less than the taxpayer's basis in the old pool. *Id.* at 566-68.

The taxpayer's only motivation for the *Cottage Savings* transaction was the tax benefit offered by the recognition of losses. *Cottage Savings Ass'n v. Commissioner*, 90 T.C. 372 at 384, 388 (1988). Aside from the transaction costs it incurred, the taxpayer's economic position was unchanged by the transaction. The taxpayer continued to have an interest in a pool of mortgages with characteristics economically identical to the pool in which it originally held an interest. The transaction produced no cash for Cottage Savings and was disregarded for regulatory and financial accounting purposes.

On these facts, the Commissioner argued that the transaction did not qualify as a sale or exchange under § 1001 because the taxpayer's economic position had not changed — *i.e.*, in substance, the taxpayer owned economically equivalent assets after the swap as before the swap. The Sixth Circuit ruled that the loss could not be recognized because the transaction was tax-motivated and had no nontax economic effects. *Cottage Savings Ass'n v. Commissioner*, 890 F.2d 848, 853-54 (6th Cir. 1989).

This Court reversed. After examining the statutory predecessors to § 1001, the language of the provision itself, the accompanying regulations, and its own earlier decisions regarding the taxation of sales and exchanges, this Court concluded that the transaction involved the exchange of "materially different properties, as required by § 1001." It accordingly rejected the Commissioner's argument that the mortgage swap should not be recognized for tax purposes. 499 U.S. at 566-68.

Here, the Third Circuit majority applied an extrastatutory requirement essentially indistinguishable from the one rejected by this Court in *Cottage Savings*. Had this Court applied the rule adopted by the Third Circuit in *Cottage*

Savings, it would necessarily have reached the opposite result because the undisputed facts there would have caused Cottage Savings to fail both prongs of the Third Circuit's test. The Third Circuit's refusal to recognize ACM's transactions under §§ 1001 and 453 on the ground that the transaction lacked appreciable nontax economic effect and a nontax motivation conflicts with this Court's holding in *Cottage Savings*.

B. *Gregory* does not grant the courts license to apply a test ungrounded in the language of the governing statutes.

Cottage Savings establishes that it is wrong for a court to apply, as a precondition for recognizing a transaction under § 1001, an extrastatutory test requiring an appreciable "non-tax economic effect" or a "subjective non-tax purpose." That conclusion follows from this Court's decision in *Gregory v. Helvering*, 293 U.S. 465 (1935). The Court there made clear that whether a transaction is to be respected for tax purposes is governed only by the requirements of the applicable statutory provisions. Tax motives are irrelevant, and tests ungrounded in the language of the governing statute have no place in the analysis.

In *Gregory*, the taxpayer sought to transfer to herself assets held by her wholly-owned corporation. If the corporation had distributed the assets directly to her, the transfer would have been a dividend taxable as ordinary income. Instead, the taxpayer caused her corporation to organize a new corporation and transfer the assets to that new entity, which then liquidated, distributing the assets to her. After the liquidation, the taxpayer sold the assets and reported capital gain from the sale. The taxpayer claimed that these steps were tax-free events under a statute shielding distributions "in pursuance of a plan of reorganization" from income taxation. The Commissioner challenged the taxpayer's position, arguing that the taxpayer's only motive was to lower her tax and that the reorganization provisions were therefore inapplicable.

This Court rejected the Commissioner's motive-based argument, declaring that the taxpayer's "ulterior purpose" should be "disregarded." The "question for determination," the Court stated, "is whether what was done, *apart from the tax motive,* was the thing *which the statute intended.*" 293 U.S. at 469 (emphasis added). This Court concluded that the taxpayer's actions lay "outside the plain intent of the statute" because the provision was intended to apply only to transactions undertaken "in pursuance of a plan of reorganization of corporate business; and not a transfer of assets by one corporation to another in pursuance of a plan having no relation to the business of either." 293 U.S. at 469-70. That is, the operative statute, by referring to a "plan of reorganization," was intended to apply only to distributions accomplishing a reorganization of a business and not to distributions made for the shareholder's personal profit.

Thus, the teaching of *Gregory* is twofold: (1) tax motive is irrelevant; and (2) whether a transaction is taxed in accordance with its form is determined solely on the basis of whether the substance of the transaction is that described by the governing statutory provision.[10] That was the question asked and answered in *Cottage Savings*: this Court determined that § 1001 applies whenever a transaction involves the exchange of "materially different" properties.

---

[10] This Court has reiterated these principles in the years since *Gregory*. For example, in *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212 (1988), this Court rejected motive as a basis for determining whether a Code section would apply to a taxpayer's transactions when the statute itself did not require an inquiry into the taxpayer's motives. In *Knetsch v. United States*, 364 U.S. 361 (1960), this Court also disregarded the taxpayer's motive and instead examined the actual transaction and the governing statutory provision to determine whether the taxpayer was entitled to an interest deduction under the predecessor to § 163. Only after determining that the existence of offsetting financial obligations between the taxpayer and the lender meant that, in economic substance, the taxpayer did not have the "indebtedness" required for an interest deduction by the statute, did this Court hold that the taxpayer was not entitled to the deduction.

499 U.S. at 566. ACM's sale of its Citicorp Notes for cash and LIBOR notes was, without question, such an exchange. The Third Circuit did not ask, and did not answer, the question mandated by *Gregory* and *Cottage Savings*. Instead, the Third Circuit asked only whether the transaction had appreciable "non-tax economic effect" or "subjective non-tax purpose."

In contrast with the approach taken by the Third Circuit, other federal courts of appeals have heeded *Gregory* and analyzed the substance of transactions in the context of the relevant Code provisions, avoiding extrastatutory quests for nontax economic benefits and nontax motives. For example, in a group of identical cases on appeal from the Tax Court and decided together as *Fabreeka Products Co. v. Commissioner*, 294 F.2d 876 (1st Cir. 1961), the court of appeals examined a series of purely tax-motivated transactions. The Commissioner admitted that the form of the taxpayers' transactions appeared to satisfy the statutory provisions but argued that there was "no reality to the transaction[s] as an investment" and that the taxpayers should therefore be denied the tax treatment required by the pertinent Code provision. *Id.* at 878. The court noted that it was faced with the task of "interpreting a statute whose apparent meaning would produce in a particular instance a result distasteful to the court," but it did not allow its visceral response to serve as an excuse for conducting a result-oriented analysis. *Id.* at 877. Concluding that "the brightness of the motive cannot be permitted to blind our eyes to the existence of substantive events," *Id.* at 878, the court noted the real economic consequences of the taxpayer's actions: the taxpayer had purchased bonds, held them for 30 days, and incurred the risk that the bonds might decline in value or be called during that period. Although the court acknowledged that the call risk to the taxpayer was "negligible," it determined that the relevant statute required nothing more to permit the deduction in question. In holding for the taxpayer, the court conceded, as the Commissioner had argued, that taxpayers had "found a hole in the dike" by engaging in transactions with arguably

unexpected favorable tax results. It characterized that "hole," however, as "one that calls for the application of the Congressional thumb, not the court's." *Id.* at 879. *See also Maysteel Products, Inc. v. Comm'r*, 287 F.2d 429 (7th Cir. 1961) (same as *Fabreeka*); *Horn v. Comm'r*, 968 F.2d 1229 (D.C. Cir. 1992) (rejecting Commissioner's attempt to bar taxpayer's invocation of statutory provision on the ground that the transaction in question lacked objective economic substance and had only a tax motivation).

Had the Third Circuit in this case correctly applied *Gregory*'s instruction to examine "what was done," it would have determined that what was done was exactly what §1001, §453, and the §453 regulations were intended to cover. ACM owned the Citicorp Notes, bore the benefits and burdens associated with ownership, and then sold the Notes. The sales were contingent payment installment sales as described in § 453(j)(2) and the § 453 regulations. Thus, ACM properly applied the ratable basis recovery rule prescribed by the regulations, and its tax reporting must be respected.

II. THIS CASE PRESENTS QUESTIONS OF COMPELLING IMPORTANCE TO THE ADMINISTRATION OF THE FEDERAL TAX LAWS.

The Third Circuit's decision in this case undermines this Court's carefully crafted balancing of the roles of the executive branch and the judiciary reflected in *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984). The decision effectively grants nonstatutory equitable relief to the Commissioner from the consequences of his own rules, and will entangle the judiciary in myriad disputes over the application of standards that cannot be applied in a principled and even-handed way.

A. The Third Circuit's decision undermines the balance between the three branches of government required by this Court's decision in *Chevron*.

The Constitution reserves to Congress the power to enact the laws and to the President the power to execute them.

Execution of the laws may be carried out by the promulgation of regulations by the administrative agencies of the executive branch. When properly promulgated in response to an explicit congressional delegation, regulations have the force and effect of law and are upheld as valid unless they are "arbitrary, capricious, or manifestly contrary to the statute." *Chevron*, 467 U.S. at 844. As was stated in *Mutual Savings Life Insurance Co. v. United States*, 488 F.2d 1142, 1145 (5th Cir. 1974), "Treasury Regulations having the force and effect of law are binding on tax officials, as well as taxpayers." *See also Estate of Delaune v. Commissioner*, 143 F.3d 995, 1005 (5th Cir. 1998); *Pacific National Bank of Seattle v. Commissioner*, 91 F.2d 103, 105 (9th Cir. 1937). In other words, the natural corollary to the broad deference granted rulemakers is that they must abide by those rules themselves.

There can be no doubt that the ratable basis recovery regulation adopted pursuant to § 453(j) is valid: it was promulgated under a specific grant of authority and is consistent with the legislative directive. Thus, it is binding on the Commissioner just as it is on taxpayers. Both Congress and the Secretary recognized that the ratable basis recovery rule would potentially distort income, but the Secretary determined that such a noneconomic effect was nonetheless appropriate. Now that the regulation has in this case produced a result different from that envisioned by the Secretary, the Commissioner has asked for relief from the consequences of the regulation even though it indisputably applies to the reporting of ACM's transaction. By asking the courts to impose on ACM a judicially created test requiring an appreciable "non-tax economic effect" or a "subjective non-tax purpose" as a prerequisite for the application of §§ 1001 and 453 and the regulations under § 453, the Commissioner subverts the fundamental principle underlying *Chevron* — that such lawmaking power must be exercised not by the courts, but by Congress and by the agency to which Congress has delegated regulatory authority.[11]

---

[11] *See also United States v. Correll*, 389 U.S. 299, 306-07 (1967) ("[W]e do not sit as a committee of revision to perfect the administration

(continued . . .)

Respect for the roles of the three branches of government mandates that, if the executive branch is dissatisfied with the results generated by a particular statute or regulation, it must seek a change to the applicable rule and not apply for *ad hoc* judicial relief. When a statute produces undesirable results, Congress may amend or repeal the offending statute. When a regulation creates such a problem, the Secretary may amend or revoke the regulation. Unsatisfactory results produced by a tax statute or regulation do not warrant the judicial intervention in which the Third Circuit engaged. As Judge McKee stated in his dissent, "[t]o the extent that the Commissioner is offended by these transactions he should address Congress and/or the rulemaking process, and not the courts." (App. at 72a).[12]

B. The Third Circuit effectively granted the Commissioner equitable relief from his own regulation.

It is apparent that what the Commissioner seeks in this case is equitable judicial relief from the operation of his own rules. But courts do not sit as courts of equity in interpreting the tax laws, and the executive branch should be no more free than taxpayers to seek equitable relief from valid Treasury Regulations. *See, e.g. United States v. Brockamp*, 117 S. Ct.

(. . . continued)

of the tax laws. Congress has delegated to the Commissioner, and not to the courts, the task of prescribing 'all needful rules and regulations for the enforcement' of the Internal Revenue Code. In this area of limitless factual variations 'it is the province of Congress and the Commissioner, not the courts, to make the appropriate adjustments.'") (citations omitted); *Hanover Bank v. Comm'r*, 369 U.S. 672, 688 n.23 (1962) (quoting the above-cited language from *Fabreeka Products Co. v. Comm'r*, 294 F.2d 876, 879 (1st Cir. 1961).

[12] If Congress wanted the courts to apply an appreciable "non-tax economic effect" or "subjective nontax purpose" test in interpreting all provisions of the Code, it would have said so explicitly. Such provisions may be found in the tax codes of other nations (*e.g.*, Canada, Australia, New Zealand).

849, 852 (1997), in which this Court rejected the notion that I.R.C. § 6511 allows equitable tolling of the statute of limitations and noted that "[t]ax law, after all, is not normally characterized by case-specific exceptions reflecting individualized equities"); *Lewyt Corp. v. Commissioner*, 349 U.S. 237, 240 (1955) ("[T]he rule that general equitable considerations do not control the measure of deductions or tax benefits cuts both ways. It is as applicable to the Government as to the taxpayer."). The Commissioner's request for equitable relief is particularly offensive in this case, where the result of which he complains — accelerated income — is exactly that which, by his regulations, he intended to impose upon taxpayers.

The Third Circuit's willingness to indulge the Commissioner's *ad hoc* departure from his own rules undermines the ability of taxpayers to rely on Treasury Regulations and therefore poses a serious threat to the orderly administration of the tax law. Moreover, granting the Commissioner equitable relief throws neutrality and predictability, fundamental to the tax system, out the window. The loss of neutrality and predictability is evinced by the Tax Court's recent decision in *ASA Investerings*. That case involved transactions similar to ACM's, except that that partnership held notes similar to the Citicorp Notes for only six days. Nevertheless, the Commissioner and the Tax Court readily recognized the substance of the transaction in that case, applying §§ 1001, 453, and the regulations under § 453, because the determination that the foreign entity in that case was not a partner led to an acceleration of taxable income for U.S. taxpayers. Thus, the Commissioner in that case reached a result directly contrary to that sought here. By litigating against the application of his own regulations here, the Commissioner has transformed a properly promulgated neutral rule into a malleable instrument that applies only when the Commissioner finds the result palatable.

C. The Third Circuit's decision will needlessly entangle the judiciary in myriad disputes over the application of standards that cannot be applied in a principled and even-handed way.

The Third Circuit's decision will mire the judiciary in arguments over the meaning of appreciable "non-tax economic effect" and "subjective non-tax purpose" with no statutory or regulatory guidance on the meaning of those terms. These are inherently uncertain standards. They will make the courts the key forum for uneven and arbitrary administration of the tax laws. Thus, the decision below will undermine the ability of taxpayers to rely on tax statutes and Treasury Regulations.

The importance of this issue is demonstrated by the fact that § 1001 is a cornerstone of the Internal Revenue Code, governing all sales or exchanges of property. Based on the decision below, whenever the Commissioner is unhappy with the tax consequences of a sale or exchange, he can argue that the transaction should be disregarded for lack of appreciable "non-tax economic effect" or "subjective non-tax purpose."

The implications of this approach are evident from the Third Circuit decision. The majority concluded that the ownership and sale of notes lacked appreciable "non-tax economic effect" under circumstances where those notes were issued by a highly-rated financial institution, earned a floating rate of interest three basis points above the interest earned on certain bank deposits, and were owned by the taxpayer for 24 days. If the Third Circuit's decision is allowed to stand, courts will inevitably be forced to address an endless cascade of questions that have no grounding in the statute or regulations: Does a "non-tax economic effect" become appreciable if the notes are issued by a less credit-worthy borrower? if the notes bear a fixed rate of interest? if they are held for 45 rather than 24 days? if the interest earned is seven rather than three basis points higher than the bank deposits?

The variations on these questions are boundless and no statute enacted nor regulation promulgated provides any guidance on how they should be answered. Yet, the majority opinion would require the courts to travel this road on myriad occasions, with only a sense of "smell" to guide them.[13] The implications for tax administration, and the resulting demands on the judiciary, justify plenary review of the decision below to determine whether — in the absence of express congressional directive — this is a journey taxpayers, tax administrators, and the courts should be compelled to take.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

WILLIAM L. GOLDMAN
CHRISTOPHER KLIEFOTH
MCDERMOTT, WILL & EMERY
600 Thirteenth Street, N.W.
Washington, D.C. 20005
(202) 756-8000

ALBERT H. TURKUS
Counsel of Record
FRED T. GOLDBERG, JR.
PAMELA F. OLSON
SKADDEN, ARPS, SLATE,
MEAGHER & FLOM LLP
1440 New York Avenue, N.W.
Washington, D.C. 20005
(202) 371-7000

Attorneys for Petitioner ACM Partnership

January 11, 1999

---

[13] This Court should also consider the wisdom of requiring the judiciary to travel such a tortured path when there is a simpler remedy available. As noted above, if the Secretary dislikes the results of his own regulations — regulations the Secretary knew would result in substantial distortions — the Secretary should change them.

APPENDICES

TABLE OF CONTENTS

APPENDIX A:

Opinion of the United States Court of Appeals for the Third Circuit, October 13, 1998 ..... 1a

APPENDIX B:

Memorandum Opinion of the United States Tax Court, March 5, 1997 ..... 1b

APPENDIX C:

I.R.C. § 453 (in pertinent part) 1c

I.R.C. § 1001 (in pertinent part) 2c

Temp. Treas. Reg. § 15a.453-1(c) (in pertinent part) 3c

APPENDIX A

Volume 1 of 2

Filed October 13, 1998

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

Nos. 97-7484 and 97-7527

ACM PARTNERSHIP,
SOUTHAMPTON-HAMILTON COMPANY,
TAX MATTERS PARTNER,
Appellant in No. 97-7484

v.

COMMISSIONER OF INTERNAL REVENUE

ACM PARTNERSHIP,
SOUTHAMPTON-HAMILTON COMPANY,
TAX MATTERS PARTNER,

v.

COMMISSIONER OF INTERNAL REVENUE
Appellant in No. 97-7527

On Appeal from the United States Tax Court
(Tax Court No. 10472-93)

Argued June 23, 1998

BEFORE: GREENBERG, ALITO, and McKEE,
Circuit Judges

(Filed October 13, 1998)

Albert H. Turkus (argued)
Fred T. Goldberg, Jr.
Pamela F. Olson
Skadden, Arps, Slate
Meagher & Flom, LLP
1440 New York Avenue, N.W.
Washington, D.C. 20005

William L. Goldman
Christopher Kliefoth
McDermott, Will & Emery
600 Thirteenth Street, N.W.
Washington, D.C. 20005

Attorneys for Appellant
and Cross Appellee ACM
Partnership, Southampton-Hamilton
Company, Tax Matters Partner

Loretta C. Argrett
Assistant Attorney General
Richard Farber
Edward T. Perelmuter (argued)
Tax Division
Department of Justice
Post Office Box 502
Washington, D.C. 20044

Attorneys for Appellee
and Cross Appellant
Commissioner of Internal Revenue

OPINION OF THE COURT

GREENBERG, *Circuit Judge.*

I. INTRODUCTION

Appellant ACM Partnership ("ACM"), through its tax matters partner Southampton-Hamilton Company ("Southampton"), appeals from a decision of the United States Tax Court dated June 12, 1997. The Tax Court's jurisdiction rested on I.R.C. §§ 7442, 6213 and 6226 based on appellant's timely filing of a petition seeking redetermination of a deficiency and review of a Final Partnership Administrative Adjustment. Appellate jurisdiction rests on I.R.C. § 7482(a)(1). Venue is proper pursuant to I.R.C. § 7482(b)(1)(A) as Southampton maintained its principal place of business within this circuit at the time it filed its petition. For the reasons that follow, we will affirm in part, reverse in part, dismiss the Commissioner of Internal Revenue's cross appeal, and remand for further proceedings.

II. FACTUAL AND PROCEDURAL HISTORY

This appeal concerns the tax consequences of a series of transactions executed between November 1989 and December 1991 by appellant ACM, a partnership formed on October 27, 1989, with its principal place of business in Curacao, Netherlands Antilles. Each of ACM's three partners was created as a subsidiary of a larger entity several days before ACM's formation. Southampton was incorporated under Delaware law on October 24, 1989, as a wholly-owned subsidiary of Colgate-Palmolive Company ("Colgate"), an international consumer products company. Kannex Corporation N.V. ("Kannex") was incorporated under Netherlands Antilles law on October 25, 1989, as an entity controlled by Algemene Bank Nederland N.V. ("ABN"), a major Dutch bank. ACM's third partner, Merrill Lynch MLCS, Inc. ("MLCS"), was incorporated under Delaware law on October 27, 1989, as a wholly owned subsidiary of Merrill Lynch Capital Services, an affiliate of the financial services holding company Merrill Lynch & Co., Inc. ("Merrill

Lynch"). *See ACM Partnership v. Commissioner*, 73 T.C.M. (CCH) 2189, 2190, 2197 (1997); app. at 81-84, 89-91.

A. The Proposed Partnership

The concept behind the ACM partnership originated in a proposal which Merrill Lynch presented to Colgate in May 1989. During the previous year, Colgate had reported $104,743,250 in long-term capital gains which were attributable in significant part to the sale of its wholly owned subsidiary The Kendall Company ("Kendall"). *See* app. at 74-75. Colgate had considered and rejected several proposals to reduce the tax liability arising from those 1988 capital gains, *see* app. at 664, when Merrill Lynch representative Macauley Taylor approached Colgate's Assistant Treasurer Hans Pohlschroeder in May 1989 and proposed an investment partnership that would generate capital losses which Colgate could use to offset some of its 1988 capital gains. App. at 674-76, 784, 965.[1]

Pohlschroeder related the plan to Colgate's Vice President of Taxation Steven Belasco, who expressed reservations because the plan entailed substantial costs, might not be recognized for tax purposes, and did not seem to serve Colgate's non-tax business purposes, and thus might not be well-received by Colgate's legal, financial, and accounting departments who would be required to participate in the plan. *See* 73 T.C.M. at 2191; app. at 1234-36. Colgate consulted a law firm for advice on the proposed transaction, which the law firm summarized as follows:

> A (a foreign entity), B, and C form the ABC Partnership (ABC) on June 30, 1989 with respective cash contributions of $75, $24 and $1. Immediately thereafter, ABC invests $100 in short-term securities which it sells

---

[1] The proposal was premised on I.R.C. §1212(a), which permits a taxpayer to carry back a capital loss to offset capital gains recognized within the preceding three years.

> on December 30, 1989, to an unrelated party. The fair market value and face amount of the short-term securities at the time of the sale is still $100. In consideration for the sale, ABC receives $70 cash and an installment note that provides for six semiannual payments . . . Each payment equals the sum of a notional principal amount multiplied by the London Interbank Offering Rate (LIBOR) at the start of the semiannual period.[2] ABC uses the $70 cash and the first payment on the installment note to liquidate A's interest in ABC and uses the subsequent interest payments to purchase long-term securities.

73 T.C.M. at 2191.

The law firm advised that the sale of the short-term securities would be reported as a contingent installment sale under the installment method which governs "dispositions[s] of property where at least 1 payment is to be received after the close of the taxable year in which the disposition occurs," I.R.C. § 453, and the ratable basis recovery rule which provides that,

> [w]hen a stated maximum selling price cannot be determined as of the close of the taxable year in which the sale or other disposition occurs, but the maximum period over which payments may be received under the contingent sale price agreement is fixed, the taxpayer's basis (inclusive of selling expenses) shall be allocated to the taxable years in which payment may be received under the agreement in equal annual increments.

---

[2] The LIBOR [London Interbank Offering Rate] is the primary fixed income index reference rate used in [European financial] markets. (Footnote is by Tax Court.)

Temp. Treas. Reg. § 15a.453-1(c)(3)(i).[3] Thus, the law firm advised, ABC would recover $25 of its basis in each of the 4 taxable years from 1989 through 1992, and ABC would recognize gain to the extent that the payments received in any year exceeded the $25 or loss to the extent that the payments fell below the $25, but only if the loss were carried over to a year with sufficient reported gains against which to offset that loss. *See* 73 T.C.M. at 2191.

On July 18, Pohlschroeder and Taylor, who had presented Merrill Lynch's proposal to Pohlschroeder's colleagues in Colgate's treasury department, discussed Colgate's concerns about the proposed partnership transaction, including its costs and its potential to serve Colgate's business purposes. Pohlschroeder's handwritten notes of the conversation read as follows:

> . . .
>
> Based on bus. purpose
> Economic profit
> Is this partnership profitable?
>
> Every single step to be substantiated
> invest in your own debt
> Consolidation of effective control but not majority ownership.

App. at 634, 791.

Colgate was interested in the concept of using the proposed partnership to invest in its own debt because of recent developments which had weighted Colgate's debt portfolio toward fixed-rate long-term debt, leaving Colgate vulnerable to a decline in interest rates.[4] Moreover, persistent

---

[3] All citations to the Internal Revenue Code and Treasury regulations with respect to both this case and the cases we cite are to the versions in effect at the time of the relevant transactions.

[4] The elevated proportion of long-term debt in Colgate's debt structure arose in part from Colgate's use of the proceeds from the Kendall

rumors that Colgate was a likely target for a hostile takeover or leveraged buyout had decreased the value of Colgate's debt issues due to the risk that Colgate's credit rating would be downgraded if Colgate became more highly leveraged. Because of these factors, Colgate perceived an opportunity to rebalance its debt profile, thus decreasing its exposure to falling interest rates, by acquiring its long-term debt issues at their presently discounted prices. *See* app. at 666-68, 880-82, 2762-63, 2765, 2769-70; 73 T.C.M. at 2192.

Colgate and Merrill Lynch discussed the possibility of using the proposed partnership to achieve these objectives. The acquisition of its own debt issues would decrease Colgate's exposure to falling interest rates because by acquiring those debt issues as an asset, Colgate effectively would reap the benefits of receiving the above-market interest payments due on those issues, thus hedging against the burdens associated with owing those payments. *See* 73 T.C.M. at 2193. Acquiring the debt through the partnership instead of directly would keep the acquisitions off Colgate's books, thus permitting Colgate to carry out its debt acquisition strategy without alerting potential acquirors to the internal accumulation of debt issues which, by increasing the capacity for internal leverage, would increase Colgate's vulnerability to a hostile takeover bid. *See* 73 T.C.M. at 2192-93; app. at 101, 3249-50, 1921-26, 2793-99, 2810, 2819-20, 3255-61. Thus, the acquisition of Colgate debt through the partnership would allow Colgate to use partnership capital to acquire its debt issues immediately at advantageous prices, then to retire and reissue the debt when market conditions were more favorable. In the interim, the debt effectively would be retired

---

sale to retire significant amounts of short-term debt and its issuance of long-term debt to finance an employee retirement plan. *See* 73 T.C.M. at 2192; app. at 77-78, 669-70, 2761, 2764-70. This high proportion of long-term fixed-rate debt exposed Colgate to risk in the event of declining interest rates, as Colgate would receive diminished returns from its cash balances and short-term deposits, but would continue to owe interest on its debts at the higher fixed rate.

because Colgate would not owe the obligations thereon to third parties, yet the debt would remain outstanding for accounting purposes, reducing Colgate's vulnerability to potential acquirors. *See* app. at 673; 73 T.C.M. at 2193.

On July 28, 1989, Merrill Lynch presented a proposed partnership transaction summary which incorporated Colgate's debt acquisition objectives into the tax reduction proposal involving the contingent installment sale which Merrill Lynch had presented to Colgate in May 1989. *See* app. at 678-79. Merrill Lynch revised its proposals throughout the summer and approached ABN about participating in the partnership with Colgate and Merrill Lynch. Merrill Lynch explained to ABN that the partnership would invest in Colgate long-term debt to serve Colgate's debt management objectives, would engage in a contingent installment sale, and would require ABN's participation for no more than 2-3 years. ABN agreed to meet with Colgate representatives in the middle of October 1989. *See* 73 T.C.M. at 2193-94.[5]

In a document dated August 17, 1989, Merrill Lynch set forth revisions to the planned partnership transactions which it had presented to Colgate on July 28, 1989. *See* app. at 275-77. This document, entitled "Revised Partnership Transaction Summary," *see* app. at 263-67, set forth the following proposal incorporating both the contingent installment sales transaction which Merrill Lynch initially had proposed in May 1989 and the debt acquisitions which Merrill Lynch had incorporated in its July 28 proposal:[6]

---

[5] ABN was familiar with its role in the proposed transaction, as Merrill Lynch had approached ABN in early 1989 while it was developing the proposal and had sought ABN's participation in a similar partnership arranged on behalf of another Merrill Lynch client. *See* 73 T.C.M. at 2194; app. at 1670-75, 1103.

[6] The August 17 transaction summary referred to Colgate as "XYZ corporation," ABN as "Partner A," and Merrill Lynch as "Partner B." However, the identity of the parties is clear from the role that each of them played in the ensuing transactions and from Pohlschroeder's testimony.

1) A Colgate subsidiary contributes $30 million, ABN contributes $169.3 million and Merrill Lynch contributes $.7 million.

2) The partnership invests its entire $200 million capitalization in short-term, floating rate private placement securities as "Interim Investments prior to the acquisition of [Colgate] debt" which are to "earn a return greater than comparably rated commercial paper or bank deposits."

3) The partnership sells the short-term notes for a combination of cash and LIBOR-based notes and uses the cash to acquire Colgate debt. "The purpose of the LIBOR notes will be to partly hedge the interest rate sensitivity of long-term [Colgate] debt acquired by the Partnership."

4) The partnership exchanges a portion of the long-term Colgate debt for newly issued medium-term Colgate debt, pursuant to a provision which affords Colgate the option of making such exchanges through the partnership.

5) The partnership adjusts its LIBOR note holdings. If the partnership retains a substantial amount of long-term debt, the Partnership "would likely . . . acquire additional LIBOR-based assets or . . . other hedges to reduce interest rate sensitivity of Partnership assets. Alternatively, if a substantial amount of long-term [Colgate] debt is exchanged, the Partnership would likely reduce its holding of LIBOR notes. Such a reduction would be necessary because the Medium-Term Debt, received in exchange for long-term [Colgate] debt, is less interest rate sensitive than the long-term [Colgate] debt. LIBOR Notes may either be sold directly or distributed to one or more Partners in a non-liquidating distribution."

See app. at 685. Except where there are direct quotations we have paraphrased the summary.

6) If the partnership has not invested all of its capital in Colgate debt and LIBOR instruments, the partnership "may liquidate some or all of the remaining Short-Term Notes and distribute the proceeds to one or more of the partners."[7]

7) "Possible redemption of [ABN's] Partnership interest. Commencing one year after formation of the Partnership, [ABN] has the right to have its Partnership interest redeemed by the Partnership . . . . The Partnership may redeem [ABN] in kind with Partnership property of its choosing or in cash. For example, assuming no change in asset values, the Partnership could borrow $169.3 million collateralized by its assets and use the proceeds to redeem [ABN]."

8) "If [ABN] is redeemed, the Partnership must be consolidated with [Colgate] for financial reporting purposes. Accordingly, all assets, including [Colgate] debt . . . will appear on the [Colgate] consolidated balance sheet. The [Colgate] debt will be effectively retired at that time. . . . [I]f the [Colgate] debt were acquired at a premium or a discount, [Colgate] would recognize a loss or gain, respectively, for income statement purposes. It would be most reasonable for the Partnership to sell the LIBOR Note . . . if [ABN] is redeemed. Since the principal asset of the Partnership, other than LIBOR Notes . . . is likely to be [Colgate] debt and [Colgate] would be a 98% partner, the hedge protection provided by the LIBOR Notes . . . is no longer necessary."

9) "After a period of years it might be advantageous for [Colgate] affiliates to purchase [Merrill Lynch's] Partnership interest. Alternatively, the Partnership might

---

[7] This item was designated "Step 7." "Step 6" addressed a possible investment in Colgate receivables as an alternative to the LIBOR notes. Because ACM did not invest in Colgate receivables, this aspect of the proposal is immaterial.

> be liquidated with [Colgate] receiving [Colgate] debt as proceeds of the liquidation."

App. at 275-77. The final page of that document addressed the tax considerations of the arrangement and stated,

> the liquidation of $200 million of Short-Term Notes in exchange for approximately $140 million of cash and $60 million market value of LIBOR notes should result in approximately $106 million of gain to the Partnership. 15% of such gain, $16 million, will be allocable to [Colgate]. If . . . LIBOR notes are distributed to [Colgate], each $10 million market value of the LIBOR notes distributed should have a tax basis of approximately $28 million. In a succeeding tax year, the Partnership will recognize a loss on sale or at maturity of the remaining LIBOR Notes. 98% of such loss will be allocable to [Colgate] because [Colgate] will be a 98% partner at such time. Combined, losses on sale of LIBOR Notes distributed to [Colgate] and losses on sale of LIBOR Notes by the Partnership should exceed $106 million. Accordingly, [Colgate] should recognize a net loss of approximately $90 million. After discounting and transactions costs . . . the transaction produces over $20 million present value benefits to [Colgate].

App. at 279.

A representative of ABN's legal department testified that the partnership, as he understood it, was to:

> enter into transactions that would create a capital gain and in a later stage a capital loss, and that . . . depending on the percentage of your participation, you would either take part in the gain or the loss. So by having us being the majority partner at the start, we would take the majority of the gain, while in a later stage one of the other partners would take the loss.

App. at 1298.

In a memorandum dated October 3, 1989, Pohlschroeder recommended the partnership to Colgate Treasurer Brian Heidtke. *See* App. at 310-21. Pohlschroeder outlined the advantages of repurchasing outstanding Colgate debt through a partnership, and stated that "[t]he partnership would temporarily invest the funds in some short-term instruments and, at the same time, start the repurchasing program." App. at 312. The memorandum identified three sets of Colgate debt issues targeted for repurchase: 1) a set of 9.625% 30-year notes due in 2017 ("Long Bonds"); 2) a set of Eurodollar debentures due in 1996 ("Euro notes"); and 3) a set of 8.4% private placement notes held by Metropolitan Life Insurance Company ("Metropolitan") and due in 1998 ("Met Notes"). The memorandum stated that "pursuant to an inquiry to Metropolitan, we feel confident that the partnership can purchase sufficient Colgate debt" to carry out the proposed plan. App. at 313-14.[8]

The memorandum's "Interest Rate Outlook" predicted that although the Federal Reserve Bank was not expected to "quickly lower interest rates in the near future," it was expected to "reduce the . . . rate" by late 1989 or early 1990 to a level that would allow Colgate to "lock in attractive medium term interest rates." App. at 311. The memorandum then analyzed the impact of a one to two percent interest rate increase or decrease on the LIBOR notes and the Colgate debt issues that the partnership expected to acquire. According to the analysis, a given decrease in interest rates would increase the value of the long-term Colgate debt and decrease the value of the LIBOR notes in roughly equal and offsetting amounts because the value of the LIBOR notes was directly dependent on interest rates whereas the value of the fixed-rate debt issues was inversely proportional to interest rates. *See* app. at 951-52, 313. Thus, the memorandum concluded, "the LIBOR

---

[8] Pohlschroder testified that as of August 1989, he had received calls from traders indicating that the Long Bonds also were potentially available for purchase. *See* app. at 688.

note is an effective hedge of fixed rate assets for the partnership." App. at 313. The memorandum stated that it would be necessary to establish a "Desired Hedge Ratio" of LIBOR holdings to long-term debt holdings, so that the partnership's assets would be "fully hedged" against changes in value due to interest rate fluctuations. App. at 314.

The memorandum recommended that Colgate proceed with the partnership as a means "to actively manage its liability structure," and stated that the "Next Steps" after executing a partnership agreement, establishing the partnership in a "Foreign Jurisdiction" and funding the partnership were the following:

> -Short-term investment securities acquired.
>
> - . . . . Disposition of short-term investment securities to fund acquisition of Colgate debt.

App. at 321.

In a document marked "REVISED 9/1/89," Merrill Lynch provided Colgate a "Cost Component Analysis," which estimated after-tax costs associated with the proposed acquisition and disposition of short-term notes and acquisition of LIBOR notes. Merrill Lynch estimated that the short-term notes would entail an "origination" cost of $1.32 million, while the "remarketing" of the LIBOR notes would cost $1.29 million in addition to $.17 million in legal expenses and $1.32 million in Merrill Lynch advisory fees. *See* app. at 294.

A September 20, 1989 document delineated the details of the proposed partnership transactions and their anticipated tax consequences under I.R.C. § 453 and the ratable basis recovery rule, Temp. Treas. Reg. § 15a.453. *See* app. at 296-308. The document contemplated using the partnership's $200 million in cash investments to acquire short-term notes, *see* app. at 303, disposing of the short-term notes in exchange for $140 million in cash and LIBOR instruments which would generate contingent payments with a present value of $60 million, and using the $140 million in cash to purchase

Colgate debt. App. at 300-01, 304-05. Because the partnership was to receive payments on the exchange over the course of six years, the $200 million basis in the short-term notes was to be recovered ratably over six tax years in equal increments of $33.3 million per year pursuant to § 15a.453. Thus, according to this document, the transaction would result in significant capital gains in the first year, consisting of the $106.7 million difference between the $140 million cash received that year and the $33.3 million basis recovered that year, and would result in capital losses in each of the ensuing years because the contingent payments received in each of those years considering imputed interest would fall short of the $33.3 million basis to be recovered in each of those years. *See* app. at 301. The aggregate projected capital losses in the ensuing years equaled precisely the amount of capital gains reported in the first year, and the document stated that the recognition of those losses "may be accelerated in any year subsequent to 1989 by sale of the remaining LIBOR notes." App. at 301.

The document also contemplates Colgate's increasing its share in the partnership from 15% to 97% after the partnership recognized the $106.7 million capital gain in year 1 but before it recognized the capital losses in the ensuing years. *See* app. at 305-08. According to the document, the LIBOR notes eventually would be sold for a capital loss of $80 million, 97% of which would be allocated to Colgate based on its 97% partnership interest by the time the loss was incurred. *See* app. at 304, 308-09.

At an October 12, 1989 meeting of Colgate's Board of Directors, the Directors considered the proposal and stated that it:

> had originally been presented . . . with a view toward minimizing the capital gains tax arising out of the disposition of the Kendall business. However, major changes were made . . . so that the program would provide the important business advantages of accumulating [Colgate] debt in friendly hands and permitting [Colgate] to obtain flexibility in managing the

> ratio balance between short and long term debt and the resulting interest exposure. Without these treasury advantages, management would not have recommended this transaction.
>
> . . . . Over the life of the partnership, significant tax benefits should be generated for Colgate, but even without these benefits, Colgate would earn a pre-tax return of approximately 6% on its investment.

App. at 337. According to Steven Belasco, Colgate's Vice President of Taxation, the incorporation of Colgate's debt acquisition objectives into Merrill Lynch's initial proposal afforded sufficient business advantages to overcome Colgate's hesitations about Merrill Lynch's initial proposal which served only the tax objectives of generating a capital loss to offset 1988 capital gains. *See* app. at 1235-36.

B. The Partnership

In late September and early October 1989, as Colgate was contemplating final approval of its participation in the proposed partnership, Merrill Lynch was finalizing arrangements for ABN's participation in the partnership. An ABN document dated October 11, 1989, stated that it would agree to enter the partnership on the conditions that: 1) "[t]he timing of the purchases and sales of the various securities be adhered to as proposed;" 2) "Colgate's obligation to purchase Kannex's interest in the partnership . . . is unconditional;" and 3) Merrill Lynch agrees to repurchase the securities "at par on November 29, 1989." 73 T.C.M. at 2197; app. at 1061, 1064-65.[9]

---

[9] The document referred to the securities as "MTNs" or medium-term notes. However, it is apparent from the November 29, 1989 date by which those notes were to be resold that these were the same securities which the partnership was to purchase initially and dispose of shortly thereafter in exchange for cash which would be used to purchase Colgate debt and for LIBOR notes. *See* app. at 321, 300-05.

Between October 24 and October 27, 1989, ABN established Kannex, Colgate established Southampton, and Merrill Lynch established MLCS to participate in the ACM partnership. *See* 73 T.C.M. at 2197; app. at 81-84, 89-91. The October 27, 1989 partnership agreement among these newly created entities provided that Kannex was to receive a preferred return of the first $1.24 million in any partnership profits otherwise allocable to Southampton. *See* app. at 101; 73 T.C.M. at 2198-99.[10]

On October 27, 1989, after executing the partnership agreement, the partners met and authorized Merrill Lynch to find willing sellers of Colgate debt issues, including the Euro Notes, Met Notes, and Long Bonds which had been identified in Pohlschroeder's October 3 memorandum. *See* app. at 313, 386. The partners resolved that "in order to maximize the investment return on its assets pending the acquisition" of these debt issues, Merrill Lynch was authorized "to arrange the purchase (in a private placement) of $205 million of . . . unsecured debt." App. at 386-87.

The minutes of the partnership meeting reported that Colgate's treasury department had contacted Metropolitan with a proposal to purchase $100,000,000 of the Met notes, and that Metropolitan "if interested, would come to Bermuda on November 17, 1989 in order to negotiate and make final such transaction." App. at 387.[11] Earlier in the fall of 1989, Pohlschroeder had initiated discussions with Metropolitan about selling the notes after Metropolitan contacted him to express concern about certain terms in the notes. *See* app.

---

[10] This "preferred return" provision was a component of the proposed partnership from its inception. In a document dated September 1, 1989, Merrill Lynch advised Colgate that this aspect of the partnership would cost Colgate $740,000. *See* app. at 294.

[11] Pohlschroeder had contacted Metropolitan shortly after the first partnership meeting in October 1989 and had instructed Metropolitan to send a representative to the November 17 meeting if Metropolitan was interested in selling the Met notes. *See* app. at 743.

690-91,742. Before the November 17 meeting, a Metropolitan representative left Pohlschroeder a message indicating the price at which Metropolitan was prepared to sell the Met notes. Pohlschroeder did not respond to the call. *See* 73 T.C.M. at 2200; app. at 883. Pohlschroeder previously had conferred with Merrill Lynch's Henry Yordan about acquiring the Met Notes, Euro Notes, and Long Bonds. *See* app. at 117-18; 73 T.C.M. at 2200. Pohlschroeder's handwritten memorandum of the conversations regarding the Met notes concludes with a notation of the date November 17, while his notations regarding the acquisition of the Long Bonds and Euro Notes state that Kannex would instruct Merrill Lynch after purchase of Citicorp notes which, as discussed below, were to serve as the initial short-term investment contemplated in the partnership proposals. 73 T.C.M. at 2200; app. at 880; 889-90.

C. The Transactions

On November 2, 1989, Kannex contributed $169.4 million, Southampton contributed $35 million, and MLCS contributed $0.6 million to the newly created ACM partnership for a total partnership capitalization of $205 million. *See* app. at 98. Based on these contributions, Kannex held an 82.6% share of the partnership, Southampton held a 17.1% share, and MLCS held a 0.3% share. 73 T.C.M. at 2197; app. at 98. ACM deposited the $205 million in an account at ABN's New York branch paying interest at an annual rate of 8.75%. ACM withdrew the funds the following day and purchased ten private placement Citicorp notes in an aggregate amount of $205 million. The Citicorp notes paid interest monthly at a floating rate that was to be reset monthly. The initial rate was 8.78%, three basis points above the rate the funds were earning in the ABN account.[12] On

---

[12] A basis point, a common unit of measure for interest rates, equals one one-hundredth of a percent.

November 15, 1989, Citicorp made an interest payment and reset the interest rate to 8.65%. 73 T.C.M. at 2200.

In late October 1989, before ACM's November 3 acquisition of the Citicorp notes, Merrill Lynch had approached Bank of Tokyo ("BOT") and Banque Francaise du Commerce Exterieure ("BFCE") to negotiate selling them those notes.[13] During the first week of November, Merrill Lynch forwarded BOT and BFCE specific terms of the proposed sale in which those two banks would purchase an aggregate of $175 million of the notes for $140 million in cash plus LIBOR notes providing for a five-year stream of quarterly payments with a net present value of approximately $35 million. *See* 73 T.C.M. at 2200; app. at 107-08.[14] On November 9, 1989, BOT representatives requested approval from their head office, attaching documents which set forth "all details of the transaction." On November 10, 1989, Merrill Lynch confirmed that it would sell $125 million in Citicorp notes to BOT and $50 million to BFCE. *See* app. at 111-14; 73 T.C.M. at 2200.

On November 17, 1989, ACM convened its second partnership meeting in Bermuda. A Metropolitan representative attended pursuant to Pohlschroeder's invitation to attend if interested in selling the Met Notes. After brief negotiations, ACM and Metropolitan agreed that ACM would purchase $100 million principal amount of Met Notes effective December 4, 1989. App. at 118-19, 390; 73 T.C.M. at 2201. Pohlschroeder stated that ACM would need to raise

---

[13] Pohlschroeder testified that ACM expected to sell the Citicorp notes for cash and LIBOR notes within several weeks to make the cash available to purchase Colgate debt. App. at 739-40. Pohlschroeder also stated that the Citicorp exchange was designed "to accomplish a tax aspect of the transaction." App. at 740.

[14] In negotiating the transactions with BOT and BFCE, Merrill Lynch also agreed to arrange a series of swaps which would hedge the banks' interest rate risks and provide them additional return on their purchase of the Citicorp notes. *See* 73 T.C.M. at 2206-10.

cash by the time of the December 4 purchase and that the acquisition of long-term fixed-rate debt "would create a risk to the partnership in the event that interest rates increased." Accordingly, he recommended that ACM "hedge its risk by purchasing notional principal contracts with a floating rate of interest." App. at 391. ACM thus resolved "to arrange the sale of $175 million principal amount of Citicorp Notes" to BOT and BFCE "for cash and other LIBOR-based consideration, upon substantially the terms of a draft Installment Purchase Agreement presented to the meeting . . . in order to pay Metropolitan the amounts to be due . . . and to hedge . . . exposure to interest rate changes." App. at 391.

ACM completed the sale of the Citicorp notes on November 27, 1989, in accordance with the terms which Merrill Lynch had negotiated by November 10 and which ACM had approved on November 17, selling $125 million of the notes to BOT and $50 million of them to BFCE for a total of $140 million in cash and eight LIBOR notes issued by BOT and BFCE. The LIBOR notes provided for a stream of 20 quarterly contingent payments commencing on March 1, 1990, whose amount was derived from the three-month LIBOR multiplied by a notional principal amount of $97.76 million.[15]

In exchange for the $175,000,000 Citicorp notes, ACM received consideration totaling $174,410,814, which represented the $175,000,000 value of the Citicorp notes, reduced by the $1,093,750 in transaction costs for arranging the sale of these illiquid private placement instruments, but increased by the $504,564 in interest that had accrued on the Citicorp notes during the 12 days since their last interest payment on November 15. Accordingly, the LIBOR notes effectively cost ACM $35,504,564, the difference between the $175,504,564 in value which ACM relinquished and the

---

[15] The notional principal amount did not represent an amount owed, but rather was designated as a multiplier to determine the amount of the LIBOR-based contingent payments.

$140,000,000 in cash which ACM received in return, but had a present value of $34,410,814 to reflect the $1,093,750 in transaction costs. *See* 73 T.C.M. 2201 02, 2206-10; app. at 751. The LIBOR notes issued by BOT accounted for $25,360,403 of the aggregate cost and $24,579,153 of the aggregate present value, while those issued by BFCE accounted for $10,144,161 of the aggregate cost and $9,831,661 of the aggregate present value of the LIBOR notes acquired in the exchange. *See* 73 T.C.M. at 2201.

Upon selling the Citicorp notes on November 27, ACM invested the $140 million in cash proceeds in time deposits and certificates of deposit due seven days later on December 4, 1989, and bearing interest at 8.15% to 8.20%. In several transactions between December 4 and 8, ACM purchased Colgate debt including $100 million of the Met Notes pursuant to the November 17 agreement, $5 million of the Euro Notes, and $31 million of the Long Bonds. *See* app. at 118-20. ACM purchased an additional $18.75 million in Colgate long-term debt issues between June and October 1990. *See* 73 T.C.M. at 2205; app. at 119-20, 122-23.

During the weeks preceding ACM's November 27 acquisition of the LIBOR notes, Merrill Lynch began arranging to sell a portion of them. In a November 13, 1989 memorandum entitled "Analysis of Partnership Hedging Activity," Merrill Lynch stated that certain events would warrant a reduction in the desired amount of LIBOR holdings. Specifically, Merrill Lynch explained that if Southampton elected to increase its share of the partnership's interest rate risk, as it was entitled to do under a provision of the partnership agreement, *see* app. at 101; 73 T.C.M. at 2198-99, or if ACM exchanged the Long Bonds for a new issue of five-year Colgate debt, ACM should reduce its LIBOR note holdings in light of its diminished need for their hedging function. *See* 73 T.C.M. at 2202. Merrill Lynch approached a major Danish bank, Sparekassen SDS ("Sparekassen"), offering it the BFCE LIBOR notes which totaled approximately $10 million, along with collateral swaps which

provided Sparekassen risk protection and a return on its investment. On December 5, 1989, Sparekassen set aside a $10 million credit line in preparation for the transaction. *See* 73 T.C.M. at 2202.

At ACM's third partnership meeting on December 12, 1989, Southampton elected to increase its share of ACM's interest rate exposure and ACM exchanged a portion of the Long Bonds for shorter-term debt issues pursuant to "the terms of a Note Purchase Agreement presented to the meeting." *See* app. at 101, 396-97; 73 T.C.M. at 2205. Merrill Lynch advised that ACM decrease its LIBOR note holdings in light of these factors reducing its interest rate exposure. App. at 397. ACM resolved to distribute the BFCE LIBOR notes to Southampton as a return of contributed capital, and executed Assignment Agreements conveying those notes to Southampton. *See* app. at 124, 398.

On December 22, 1989, Southampton sold the BFCE notes to Sparekassen for aggregate consideration of $9,406,180, an amount $425,481 below the $9,831,661 present value of the notes when ACM acquired them on November 27. *See* app. at 125-26; 73 T.C.M. at 2201, 2202-03 & n.10. Of this discrepancy, $390,000 resulted from the transaction costs and bid-ask spread necessary to market the LIBOR notes, while the remaining shortfall resulted from the decreased value of the notes due to the decline in interest rates since November 27 and from a quarterly payment on the notes which reduced their remaining value. *See* 73 T.C.M. at 2202; app. at 1560-61, 1628.

On June 25, 1991, Colgate acquired a 38.31% share in ACM from Kannex for $85,897,203.60 and Southhampton acquired an additional 6.69% share from Kannex for $15,000,000, giving Colgate-Southampton a majority interest in ACM. App. at 131-32, 414. Because it had acquired a majority interest in ACM, Colgate consolidated ACM's holdings with its own on its books, revealing its control of the debt issues which theretofore had remained outstanding on its books. *See* app. at 3249-50. ACM retained $30 million in

Citicorp notes until October 16, 1991, when it put them to Citicorp at par pursuant to an option provision. ACM earned $4,329,191 of interest on the portion of the Citicorp notes which it held until 1991. *See* app. at 507-67, 570-98.

On November 27, 1991, ACM redeemed Kannex's remaining partnership interest for $100,775,915, leaving Colgate and Southampton with a combined 99.7% interest in ACM. App. at 137-38. At a December 5, 1991 partnership meeting, Merrill Lynch stated that because Colgate owned virtually the entire partnership, its "net economic exposure to the risk of interest rate fluctuations in the value of the Colgate debt was effectively minimal, and the Partnership need not maintain its position in the [LIBOR notes] to hedge against such exposure." App. at 408. Thus, Merrill Lynch explained, without the need for hedging, it was "unwise for the Partnership to hold" this "highly volatile investment" given the market's declining interest rates. ACM resolved to sell its remaining LIBOR notes, which were those issued by BOT, the BFCE LIBOR notes having been distributed to Southampton and subsequently sold to Sparekassen. App. at 409. On December 17, 1991, ACM sold the BOT LIBOR notes to BFCE for $10,961,581, a price that reflected a significant loss in value due to declining interest rates which had reduced the three-month LIBOR from 8.5% to 5.7% and transaction costs of $440,000 arising from the bid-ask spread needed to remarket the notes. *See* 73 T.C.M. at 2206; app. at 138.

D. Tax and Financial Accounting of the Transactions

On its partnership return for the tax year ended November 30, 1989, ACM treated the November 27, 1989 exchange of the Citicorp notes as an installment sale under I.R.C. § 453, as ACM was to receive part of the consideration for that exchange "after the close of the taxable year in which the disposition occurs" pursuant to § 453(b)(1). App. at 109. Because the quarterly LIBOR note payments would vary based on fluctuations in the LIBOR, there was no "stated maximum

selling price" that could be identified "as of the close of the taxable year in which the . . . . disposition occurs." Thus, the transaction came within the terms of Temp. Treas. Reg. § 15a.453-l(c), whose ratable basis recovery rule provides that the taxpayer's basis "shall be allocated to the taxable years in which payment may be received under the agreement in equal annual increments."

Accordingly, ACM divided its $175,504,564 basis in the Citicorp notes, consisting of their $175 million purchase price and $504,564 of accrued payable interest, equally among the six years over which payments were to be received in exchange for those notes, and thus recovered one sixth of that basis, or $29,250,761, during 1989.[16] Subtracting this basis from the $140 million in cash consideration for the Citicorp notes, ACM reported a 1989 capital gain of $110,749,239.42 which it allocated among its partners according to their partnership shares, resulting in an allocation of $91,516,689 of the gain to Kannex, $18,908,407 to Southampton, and $324,144 to MLCS. *See* app. at 109, 144-66; 73 T.C.M. at 2203. Southampton and MLCS were subject to United States income tax on their respective shares of the gain, but Kannex as a foreign corporation was not. App. at 226-35.[17]

Under the ratable basis recovery rule the tax basis remaining to be recovered over the following five years became $146,253,803, representing the difference between the $175,504,564 value of the Citicorp notes which ACM relinquished to acquire those notes and the $29,250,761 in basis recovered during the first year of the transaction. *See*

---

[16] ACM divided the basis across six years instead of five, although the LIBOR payments were to be received over 20 quarters commencing in 1990, because it received the cash portion of the consideration three days before the end of the 1989 tax year, making 1989 a year "in which payment may be received" under §15a.453.

[17] According to the Tax Court the share allocated to Kannex was not taxed in any jurisdiction but we, of course, are focusing only on the United States tax aspects of the transaction.

app. at 110. Of the $146,253,803 reported as the remaining unrecovered tax basis after 1989, $41,786,801 was attributable to the BFCE LIBOR notes, whose actual cost was $10,144,161, while $104,467,002 was attributable to the BOT LIBOR notes, whose actual cost was $25,360,403. *See* 73 T.C.M. at 2201, 2203 & n.11.

On its 1989 tax return, Southampton reported its $18,908,407 share of the capital gain from the $140,000,000 cash received in exchange for the Citicorp notes, and reported a $32,429,839 capital loss from its December 22, 1989 sale to Sparekassen of the BFCE LIBOR notes which it had received in the December 12, 1989 distribution from ACM.[18] Because these capital losses completely offset the capital gains, Southampton reported a net 1989 capital loss of $13,521,432 and did not report any net tax liability on its share of ACM's gain from the disposition of the Citicorp notes. *See* 73 T.C.M. at 2203.

ACM retained the Curacao office of Arthur Andersen & Co. as its accountants. In reviewing ACM's financial and tax accounting for 1989, the Arthur Andersen auditors noted that ACM's records were inconsistent in their treatment of the $1,093,750 spread between the amount of consideration ACM had paid for the LIBOR notes and their market value at the time of acquisition. Specifically, the auditors noted, ACM had not accounted for this transaction cost in its income statement, but had included it in the book value of the LIBOR notes contrary to a provision in the partnership agreement requiring that assets be recorded at fair market value. Due to this discrepancy, ACM's records effectively overstated the market value of the LIBOR notes and understated the transaction costs involved in acquiring them through the contingent installment sale. *See* 73 T.C.M. at 2204.

---

[18] This $32,429,839 loss was computed based upon the $9,406,180 cash proceeds from the sale, minus the $41,786,601 tax basis in the notes, minus $48,693 in accrued interest payable on the notes. *See* 73 T.C.M. at 2203.

The audit manager wrote the following memorandum in February 1990 to his colleagues regarding the discrepancy:

> Colgate does not want the cost to sell [the Citicorp notes] of US $1,093,750 . . . in the . . . income statement of ACM. The reasons are mainly tax driven, as inclusion might set the IRS on top of the reasons why the partnership was constructed in the first place and thus the planned tax losses might be denied by the IRS. We . . . were requested to think with Colgate in order to keep the cost to sell out of the balance sheet.

Id.; *see* also app. at 141. Arthur Andersen proposed that to avoid accounting for the costs associated with the LIBOR notes, ACM could continue to record the transaction costs as part of the value of the LIBOR notes and could resolve the conflict with the market valuation provision of the partnership agreement by issuing "a side letter to the partnership agreement stating that the LIBOR notes are the one exception to the valuation rules which now state valuation at market and would . . . then state valuation at market increased by the cost to sell the original Citicorp notes." *Id.*

At its February 28, 1990 partnership meeting, ACM adopted this approach and enacted special valuation rules which provided that the LIBOR notes, unlike other partnership assets, would be valued on ACM's books "at cost" rather than at market value and would be adjusted upon distribution of the note to a partner, redemption of the partnership interest of any partner, or liquidation of the partnership. *See* app. at 402, 407.[19] This provision effectively transferred the transaction costs associated with exchanging the Citicorp notes for LIBOR notes to the partner that eventually received the notes in a distribution, as the market value would be less than the reported value of the distribution.

---

[19] The rules described the LIBOR notes as the "[c]ontingent payment notes with no stated principal value, with payments resulting from the product of a notional amount and a floating rate of interest." App. at 407.

See 73 T.C.M. at 2204. Thus, ACM's December 12, 1989 distribution of the BFCE LIBOR notes effectively passed those transaction costs to Southampton in accordance with the partners' understanding that Colgate and Southampton would bear the transaction costs associated with trading private placement notes. *See* app. at 1622-25.

For its tax year ended December 31, 1991, ACM reported a capital loss of $84,997,111 from its December 17, 1991 sale of the BOT LIBOR notes.[20] This loss consisted of the difference between the $10,961,581 that ACM received for those notes and the remaining $95,958,692 basis in those notes. App. at 202-25. Of this amount of loss, $5.8 million resulted from a decline in the value of the LIBOR notes due to declining interest rates while $79,106,599 resulted from the application of the ratable basis recovery rule which effectively added to the tax basis of the LIBOR notes 5/6 of the $140 million value of the Citicorp notes which had been exchanged for cash. *See* 73 T.C.M. at 2206.[21] Because Colgate, together with its subsidiary Southampton, by that time owned 99.7% of the partnership, Colgate claimed 99.7% of the $84,997,111 capital loss on its 1991 return for a total capital loss of

---

[20] This appeal concerns adjustments to ACM's 1989 and 1991 tax returns. Although the Commissioner's Final Partnership Administrative Adjustment and the Tax Court's decision made adjustments to ACM's 1990 tax return, these adjustments affected only the basis in certain assets with no effect on net tax liability for 1990. *See* app. at 3444. Thus, we do not discuss the 1990 return further.

[21] Had it not applied the ratable basis recovery rule, ACM would have subtracted from the consideration it received upon disposition of the BOT LIBOR notes only the remaining portion of the LIBOR notes' aggregate $35,504,564 actual cost basis rather than the remaining portion of their aggregate $175,504,564 tax basis which ACM derived by aggregating the $140 million cash portion of the Citicorp note transaction with the $35 million LIBOR note portion of the transaction and adjusting the aggregate basis for accrued interest, yielding $95,958,692 in unrecovered basis at the time of the disposition of the BOT LIBOR notes. ACM also treated a portion of the proceeds from the notes as interest income rather than capital gains. *See* 73 T.C.M. at 2206; app. at 3388.

$84,537,479. App. at 247-51. Colgate then filed an amended 1988 return reporting this loss as a carryback pursuant to I.R.C. § 1212 to offset a portion of its 1988 capital gains. *See* app. at 252-62. [22]

E. The Tax Court Decision

On March 12, 1993, the Commissioner of Internal Revenue ("Commissioner") issued ACM a Notice of Final Partnership Administrative Adjustment ("FPAA") eliminating ACM's $110,749,239.42 installment gain from the sale of the Citicorp notes in November 1989, redetermining ACM's tax basis in the BFCE LIBOR notes distributed in December 1989, and disallowing the $84,997,111 capital loss deduction which ACM reported in 1991. *See* app. at 28-42. In writing this opinion we primarily focus on the capital loss aspects of the case, though it should be understood that the gain and loss are part of a single integrated plan. The Commissioner asserted in the FPAA that the transactions involving the purchase and sale of the Citicorp notes in exchange for cash and LIBOR notes, "were shams in that they were prearranged and predetermined. . . . [S]aid transactions were devoid of economic substance necessary for recognition for federal income tax purposes and were totally lacking in economic reality. The transactions were created solely for tax motivated purposes without any realistic expectation of profit." App. at 39. On May 24, 1993, Southampton, in its capacity as ACM's tax matters partner, filed a petition in the Tax Court contesting the Commissioner's adjustments.[23] ACM argued that its transactions

> were bona fide arm's length transactions at fair market value and had economic substance. . . . The purchase of the Citicorp notes on November 3, 1989, and the sale of

---

[22] This capital loss of $84,537,479, combined with Colgate's reported 1989 net capital loss of $13,521,432, gave rise to total reported capital losses of $98,058,911 over the course of Colgate's participation in ACM's transactions. *See* 73 T.C.M. at 2206.

[23] A designated tax matters partner represents the partnership in proceedings before the Tax Court. See I.R.C. §§ 6231(a)(7), 6226(a).

> a portion of the Citicorp notes on November 27, 1989, were not prearranged or predetermined, and both had economic substance. . . . . The sale of the Citicorp notes by ACM in exchange for fixed payments and contingent payments under the LIBOR Notes qualified for installment sale treatment under Treas. Reg. § 15a.453-l(c)(3).

App. at 25.

The Tax Court tried the case over a month-long period in 1996 and on March 5, 1997, issued a memorandum opinion upholding the Commissioner's adjustments on the grounds that "[a] taxpayer is not entitled to recognize a phantom loss from a transaction that lacks economic substance." 73 T.C.M. at 2215. In reaching the conclusion that ACM was not entitled to deduct its claimed capital losses, the court examined the stated purposes and anticipated economic consequences of the transaction, and found that the claimed losses were "not economically inherent in" the transactions but rather were "created artificially" by machinations whose only purpose and effect was to give rise to the desired tax consequences. *Id.* On April 4, 1997, ACM moved for reconsideration of the court's opinion, arguing that the transactions had sufficient economic substance to be respected for tax purposes. *See* app. at 3311-47. The court denied the motion on June 9, 1997. *See* app. at 3439-41.

The parties filed memoranda, pursuant to Tax Court Rule of Practice and Procedure 155, regarding the computation of tax liability in accordance with the Tax Court's memorandum opinion. *See* app. at 3385-444. ACM proposed a computation which disallowed deductions for the losses resulting from its application of the ratable basis recovery rule but which allowed the deduction of approximately $6,000,000 in actual economic losses resulting from the loss in value of the LIBOR notes. *See* app. at 3348-51, 3385-98. In a decision entered June 12, 1997, the Tax Court rejected ACM's computations and eliminated the entire $84,997,111 capital loss reported in 1991 as well as the 1989 capital gains reported in the first year of the Citicorp note transaction. *See* app. at 3444. ACM

filed a timely notice of appeal on September 8, 1997. *See* app. at 39-40. The Commissioner filed a protective cross appeal seeking to preserve the right to proceed on alternate theories for sustaining the adjustments in the event that the Tax Court's application of the economic substance doctrine were reversed. *See* app. at 3447.[24]

III. DISCUSSION

A. Economic Substance and the Sham Transaction Doctrine

We must decide whether the Tax Court erred in disallowing ACM's claimed $110,749,239.42 capital gain in 1989 and its $84,997,111 capital loss which the court characterized as a "phantom loss from a transaction that lacks economic substance." 73 T.C.M. at 2215. While we conduct plenary review of the Tax Court's legal conclusions, we review its factual findings, including its ultimate finding as to the economic substance of a transaction, for clear error. *See Fredericks v. Commissioner*, 126 F.3d 433, 436 (3d Cir. 1997); *Harbor Bancorp v. Commissioner*, 115 F.3d 722, 727 (9th Cir. 1997), *cert. denied*, 118 S. Ct. 1035 (1998); *Northern Indiana Pub. Serv. Co. v. Commissioner*, 115 F.3d 506, 510 (7th Cir. 1997); *Ferguson v. Commissioner*, 29 F.3d 98, 101 (2d Cir. 1994); *Lukens v. Commissioner*, 945 F.2d 92, 97 (5th Cir. 1991); *Karr v. Commissioner*, 924 F.2d 1018, 1022 (11th Cir. 1991); *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89, 92 (4th Cir. 1985).[25]

---

[24] Inasmuch as we agree with the Tax Court's decision sustaining the adjustments based on the lack of economic substance behind the transactions, we, like the Tax Court, need not consider the Commissioner's alternate theories. *See* 73 T.C.M. at 2190. In view of the elimination of the 1989 gain the parties apparently were spared from applying the complex mitigation provisions in the Internal Revenue Code. *See Koss v. United States*, 69 F.3d 705 (3d Cir. 1995), *cert. denied*, 117 S.Ct. 54 (1996).

[25] We review findings of ultimate fact, like other findings of fact, only for clear error, contrary to our former practice of reviewing such findings

ACM contends that, because its transactions on their face satisfied each requirement of the contingent installment sale provisions and regulations thereunder, it properly deducted the losses arising from its "straightforward application" of these provisions, which required it to recover only one sixth of the basis in the Citicorp notes during the first of the six years over which it was to receive payments. *See* Temp. Treas. Reg. § 15a.453-l(c).[26] Thus, ACM contends, it properly subtracted the basis in the LIBOR notes to include the remaining five sixths of the basis in the Citicorp notes used to acquire them.[27] Consequently, ACM argues it properly subtracted the approximately $96 million remaining unrecovered basis in the BOT LIBOR notes from the approximately $11 million consideration it received upon disposition of those notes, *see* br. at 32; app. at 202-03, and correctly recognized and reported the gains and losses arising from its sale or exchange of property in accordance with I.R.C. §1001.

---

de novo. *See Geftman v. Commissioner*, _ F.3d _, 1998 WL 460172, No. 97-7313, slip op. at 11 n.9 (3d Cir. Aug. 10, 1998); *Pleasant Summit Land Corp. v. Commissioner*, 863 F.2d 263, 268 (3d Cir. 1988).

[26] Although the LIBOR notes generated 20 quarterly payments spanning five years rather than six, ACM reported the "maximum period over which payments may be received under the contingent sale price agreement" as six years by including the year of the disposition in which it received the $140 million cash payment, although no quarterly payments were to be received before the tax year ended on November 30, 1989, three days after the disposition. *See* 73 T.C.M. at 2200.

[27] The basis in the LIBOR notes was derived from the basis in the Citicorp notes which ACM exchanged for the LIBOR notes. *See* I.R.C. § 1031(d). Because ACM recovered one sixth of the basis of the Citicorp notes, or $29,250,761, during the first year of the transaction, the basis in the LIBOR notes after that year was $146,253,283. *See* app. at 110. While the actual cost basis of the LIBOR notes amounted to the $35,504,564 difference between the value of the Citicorp notes that ACM relinquished and the $140 million in cash that ACM received in return, under the ratable basis recovery rule, the cash portion of the transaction was aggregated with the contingent exchange portion of the transaction, effectively adding the $140 million in cash to the tax basis of the LIBOR notes.

While ACM's transactions, at least in form, satisfied each requirement of the contingent installment sale provisions and ratable basis recovery rule,[28] ACM acknowledges that even where the "form of the taxpayer's activities indisputably satisfie[s] the literal requirements" of the relevant statutory language, the courts must examine "whether the substance of those transactions was consistent with their form," br. at 21, because a transaction that is "devoid of economic substance . . . simply is not recognized for federal taxation purposes." *Lerman v. Commissioner*, 939 F.2d 44, 45 (3d Cir. 1991).

We begin our economic substance analysis with *Gregory v. Helvering*, 293 U.S. 465, 55 S.Ct. 266 (1935), the Supreme Court's foundational exposition of economic substance principles under the Internal Revenue Code. In *Gregory*, as in this case, the transactions on their face satisfied "every element required by" the relevant statutory language. *Gregory*, 293 U.S. at 468, 55 S.Ct. at 267.[29] The taxpayer, instead of transferring stock from her

---

[28] ACM exchanged the Citicorp notes, which as private placement securities were eligible for treatment under the contingent installment sale provisions, *see* I.R.C. § 453(k)(2)(A), for the LIBOR notes' stream of quarterly payments over 20 quarters so that "at least 1 payment" was to be "received after the close of the taxable year in which the disposition occurs." § 453(b). Because the amount of each quarterly payment would depend on the variable three-month LIBOR, the "maximum selling price" could "not be determined as of the close of the taxable year in which the . . . disposition occurr[ed]." Temp. Treas. Reg. § 15a.453-1(c). Accordingly, ACM's transactions satisfied the literal terms of each requirement necessary to trigger the application of the ratable basis recovery rule providing for recovery of the basis of the relinquished assets "in equal annual increments" over each of the "taxable years in which payment may be received." § 15a.453-1(c).

[29] We analyze the economic substance of ACM's transactions according to principles that were well established when the transactions occurred, but note that partnership transactions carried out on or after May 12, 1994, also would be subject to Treasury Regulations which provide that partnership transactions "must be entered into for a substantial business purpose," that the "[t]he form of each partnership transaction must be respected under substance over form principles," and that "the tax consequences . . . to each partner of partnership operations . . . must accurately reflect the partners' income

wholly-owned corporation directly to herself which would have generated taxable dividends, created a new corporation, transferred the stock to the new corporation, then liquidated the new corporation, transferred the stock to herself, and asserted that she had not recognized any taxable gain because she had received the stock "in pursuance of a plan of reorganization" within the meaning of I.R.C. § 112(g). Although the transactions satisfied each element of the statute, which defined "reorganization" as a transfer of assets between corporations under common control, the Court found that "[t]he whole undertaking, though conducted according to the [statutory] terms . . . was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization." *Id.* at 469, 55 S.Ct. at 268.

The Court stated that "if a reorganization in reality was effected" any "ulterior [tax avoidance] purpose . . . will be disregarded" and the transaction will be respected for tax

---

agreement." Treas. Reg. § 1.701-2(a). These regulations further provide that "if a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability . . . the Commissioner can recast the transaction for federal tax purposes" by determining that "[t]he partnership's items of income, gain, loss, deduction or credit should be reallocated . . . or [t]he claimed tax treatment should otherwise be adjusted or modified." Treas. Reg. §1.701-2(b).

The regulations set forth, as an example of a transaction whose tax consequences would be altered or disregarded thereunder, a transaction in which a foreign corporation, a domestic corporation, and a promoter form a partnership "[p]ursuant to a plan a principal purpose of which is to generate artificial losses and thereby shelter from federal taxation a substantial amount of income," and engage in a series of offsetting purchases and sales in which "any purported business purpose for the transaction is insignificant in comparison to the tax benefits that would result if the transaction were respected for federal tax purposes." Treas. Reg. § 1.701-2(d), Example 7. Because these regulations do not apply to ACM's transactions, which were completed well before the 1994 effective date of the regulations, we have no occasion to consider whether the economic substance analysis required under these regulations would differ from the analysis required under the judicially defined economic substance doctrines that we apply.

purposes. *Id.*, 55 S.Ct. at 267. The Court emphasized, however, that where the transactions merely "put on the form of a corporate reorganization as a disguise for concealing its real character" which was a "preconceived plan . . . not to reorganize a business," but rather "to transfer . . . . shares to the [taxpayer]," the transaction was not, in reality, "the thing which the statute intended." Viewed according to their substance rather than their form, the Court found, the transactions fell "outside the plain intent of the statute" and therefore could not be treated in accordance with their form without "exalt[ing] artifice above reality." *Id.* at 469-70, 55 S.Ct. at 267-68. Thus, pursuant to *Gregory*, we must "look beyond the form of [the] transaction" to determine whether it has the "economic substance that [its] form represents." *Kirchman v. Commissioner*, 862 F.2d 1486, 1490 (11th Cir. 1989), because regardless of its form, a transaction that is "devoid of economic substance" must be disregarded for tax purposes and "cannot be the basis for a deductible loss." *Lerman*, 939 F.2d at 45; *accord United States v. Wexler*, 31 F.3d 117, 122 (3d Cir. 1994).[30]

In applying these principles, we must view the transactions "as a whole, and each step, from the commencement . . . to the consummation . . . is relevant." *Weller v. Commissioner*, 270 F.2d 294, 297 (3d Cir. 1959); *accord Commissioner v. Court Holding Co.*, 324 U.S. 331, 334, 65 S.Ct. 707, 708 (1945). The inquiry into whether the taxpayer's transactions had sufficient economic substance to be respected for tax purposes turns on both the "objective economic substance of the transactions" and the "subjective business motivation" behind them. *Casebeer v. Commissioner*, 909 F.2d 1360, 1363 (9th Cir. 1990); *accord*

---

[30] The courts have distinguished between "shams in fact" where the reported transactions never occurred and "shams in substance" which "actually occurred but that lack the substance their form represents." *Kirchman*, 862 F.2d at 1492; *accord Lerman*, 939 F.2d at 49 n.6. Because it is undisputed that ACM's transactions actually occurred, we confine our inquiry to the question of whether their economic substance corresponds to their form.

Lerman, 939 F.2d at 53-54 (noting that sham transaction has been defined as a transaction that "has no business purpose or economic effect other than the creation of tax deductions" and holding that taxpayer was not entitled "to claim 'losses' when none in fact were sustained"). However, these distinct aspects of the economic sham inquiry do not constitute discrete prongs of a "rigid two-step analysis," but rather represent related factors both of which inform the analysis of whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes. *Casebeer*, 909 F.2d at 1363; *accord James v. Commissioner*, 899 F.2d 905, 908-09 (10th Cir. 1990); *Rose v. Commissioner*, 868 F.2d 851, 854 (6th Cir. 1989). For the reasons that follow, we find that both the objective analysis of the actual economic consequences of ACM's transactions and the subjective analysis of their intended purposes support the Tax Court's conclusion that ACM's transactions did not have sufficient economic substance to be respected for tax purposes.[31]

---

[31] While it is clear that a transaction such as ACM's that has neither objective non-tax economic effects nor subjective non-tax purposes constitutes an economic sham whose tax consequences must be disregarded, and equally clear that a transaction that has both objective non-tax economic significance and subjective non-tax purposes constitutes an economically substantive transaction whose tax consequences must be respected, it is also well established that where a transaction objectively affects the taxpayer's net economic position, legal relations, or non-tax business interests, it will not be disregarded merely because it was motivated by tax considerations. *See, e.g., Gregory*, 293 U.S. at 468-69, 55 S.Ct. at 267 ("if a reorganization in reality was effected . . . the ulterior purpose will be disregarded"). *Northern Indiana Pub. Serv. Co.*, 115 F.3d at 512 (emphasizing that *Gregory* and its progeny "do not allow the Commissioner to disregard economic transactions . . . which result in actual, non-tax-related changes in economic position" regardless of "tax-avoidance motive" and refusing to disregard role of taxpayer's foreign subsidiary which performed a "recognizable business activity" of securing loans and processing payments for parent in foreign markets in exchange for legitimate profit); *Kraft Foods Co. v. Commissioner*, 232 F.2d 118, 127-28 & n.19 (2d Cir. 1956) (refusing to disregard tax effects of debenture issue which "affected . . . legal relations" between taxpayer and its corporate parent by financing subsidiary's acquisition of venture used to further its non-tax business interests). In analyzing both the objective

1. *Objective Aspects of the Economic Sham Analysis*

In assessing the economic substance of a taxpayer's transactions, the courts have examined "whether the transaction has any practical economic effects other than the creation of income tax losses," *Jacobson v. Commissioner*, 915 F.2d 832, 837 (2d Cir. 1990) (citations and internal quotations omitted), and have refused to recognize the tax consequences of transactions that were devoid of "nontax substance" because they "did not appreciably affect [the taxpayer's] beneficial interest except to reduce his tax." *Knetsch v. United States*, 364 U.S. 361, 366, 81 S.Ct. 130, 135 (1960). In *Knetsch*, the taxpayer had purchased annuity savings bonds from an insurance company, borrowed virtually their entire value against them, made payments back to the insurance company, and characterized those payments as deductible interest. Because the borrowing against the bonds had reduced their value to a mere "pittance," leaving the taxpayer with nothing of value apart from tax deductions, the Court concluded that the net effect of the transfers between the taxpayer and the insurance company amounted only to payment of a "fee for providing the facade of 'loans' whereby the [taxpayers] sought to reduce their . . . taxes" and therefore could not be characterized as payment of interest on a debt. *Id.* at 366, 81 S.Ct. at 135 (citation and internal quotation omitted).

In *Weller*, 270 F.2d 294, we examined a similar series of transactions in which the taxpayer purchased annuity policies, pledged them as collateral to borrow funds, used the borrowed funds to prepay future annual premiums on the policies, prepaid 'interest' on an anticipated additional loans against the policies, then used the proceeds of the additional loans to repay the earlier

---

and subjective aspects of ACM's transaction in this case where the objective attributes of an economically substantive transaction were lacking, we do not intend to suggest that a transaction which has actual, objective effects on a taxpayer's non-tax affairs must be disregarded merely because it was motivated by tax considerations.

loans, and sought to deduct the prepayments as interest. *See id.* at 295-96. Applying *Gregory*, we disallowed the deduction on the grounds that "transactions which do not vary control or change the flow of economic benefits are to be dismissed from consideration" if they "do not appreciably change the taxpayer's financial position." *Id.* at 297 (citations and internal quotations omitted). We therefore disregarded the transactions for tax purposes even though the taxpayer had made actual payments which satisfied the statutory definition of an "amount paid . . . on indebtedness incurred . . . to purchase a single premium life insurance contract," much as the Supreme Court had disregarded the transaction in *Gregory* despite the fact that the taxpayer had created "a real, valid, corporate entity" and carried out a transaction that was "within the terms of the statute." *Id.* at 296-98.

In the context of property dispositions, the courts have applied the economic substance doctrine in a similar manner to disregard transactions which, although involving actual transactions disposing of property at a loss, had no net economic effect on the taxpayer's economic position, either because the taxpayer retained the opportunity to reacquire the property at the same price, or because the taxpayer offset the economic effect of the disposition by acquiring assets virtually identical to those relinquished. *See, e.g., Lerman*, 939 F.2d at 48; *Merryman v. Commissioner*, 873 F.2d 879 (5th Cir. 1989); *Kirchman*, 862 F.2d at 1488, 1492-93; *Yosha v. Commissioner*, 861 F.2d 494, 501 (7th Cir. 1988). Although the taxpayers in these cases actually and objectively disposed of their property, the courts examined the dispositions in their broader economic context and refused to recognize them for tax purposes where other aspects of the taxpayers' transactions offset the consequences of the disposition, resulting in no net change in the taxpayer's economic position. In light of these cases, we must determine whether the Tax Court erred in concluding that ACM's exchange of the Citicorp notes for contingent-payment LIBOR notes which gave rise to the tax consequences at issue generated only "a phantom loss" that was not "economically

inherent in the object of the sale" and did not have "economic substance separate and distinct from economic benefit achieved solely by tax reduction." 73 T.C.M. at 2215. For the following reasons, we conclude that it did not.

2. *Objective Economic Consequences of ACM's Transactions*

While the Tax Court's analysis focused on the lack of non-tax purposes behind ACM's transactions rather than on their objective economic consequences, the court made numerous findings that were indicative of the lack of objective economic consequences arising from ACM's short-swing acquisition and disposition of the Citicorp notes between November 3 and November 27, 1989. The court noted that ACM sold the Citicorp notes "for consideration equal to [their] purchase price" and thus did not realize any gain or loss in the notes' principal value. 73 T.C.M. at 2215 n. 19.[32] Moreover, as the court observed, the lack of change in principal value was not merely coincidental, but was inherent in the terms of the notes and of the transactions in which they were traded. *See id.* at 2219-20. Likewise, the court found that the interest income generated by the notes could not have a material effect on ACM's financial position because the Citicorp notes paid interest at a rate that varied only nominally from the rate that ACM's cash contributions "were already earning . . . in . . . deposit accounts before the notes were acquired," resulting in only a $3,500 difference in yield over the 24-day holding period, a difference which was obliterated by the transaction costs associated with marketing private placement notes to third parties. *Id.* at 2218, 2220-21.

---

[32] As contemplated in transaction proposals drafted before ACM was formed, the Citicorp notes were sold for an amount equal to their purchase price. *See* app. at 275-77, 321, 300.

Volume 2 of 2

Filed October 13, 1998

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

Nos. 97-7484 and 97-7527

ACM PARTNERSHIP,
SOUTHAMPTON-HAMILTON COMPANY,
TAX MATTERS PARTNER,
Appellant in No. 97-7484

v.

COMMISSIONER OF INTERNAL REVENUE

ACM PARTNERSHIP,
SOUTHAMPTON-HAMILTON COMPANY,
TAX MATTERS PARTNER,

v.

COMMISSIONER OF INTERNAL REVENUE
Appellant in No. 97-7527

On Appeal from the United States Tax Court
(Tax Court No. 10472-93)

Argued June 23, 1998

BEFORE: GREENBERG, ALITO, and McKEE,
Circuit Judges

(Filed October 13, 1998)

These findings, which are amply supported by the record, demonstrate a lack of objective economic

consequences arising from ACM's offsetting acquisition and virtually immediate disposition of the Citicorp notes.[33] On November 3, 1989, ACM invested $175 million of its cash in private placement Citicorp notes paying just three basis points more than the cash was earning on deposit, then sold the same notes 24 days later for consideration equal to their purchase price, in a transaction whose terms had been finalized by November 10, 1989, one week after ACM acquired the notes.[34] These transactions, which generated the disputed capital losses by triggering the application of the ratable basis recovery rule, offset one another with no net effect on ACM's financial position. Examining the sequence of ACM's transactions as a whole as we must in assessing their economic substance, *see Court Holding Co.*, 324 U.S. at 334, 65 S.Ct. at 708; *Weller*, 270 F.2d at 297, we find that these transactions had only nominal, incidental effects on ACM's net economic position.

Viewed according to their objective economic effects rather than their form, ACM's transactions involved only a fleeting and economically inconsequential investment in and offsetting divestment from the Citicorp notes. In the course of this brief interim investment, ACM passed $175 million of its available cash through the Citicorp notes before converting 80% of them, or $140 million, back into cash while using the

---

[33] Because we find that the lack of objective economic consequences of ACM's transactions, which is evident from the Tax Court's well-supported factual findings, is essential to assessing whether the transaction's tax consequences may be disregarded and lends significant support to the court's ultimate finding that ACM's transactions did not have sufficient substance to be recognized for tax purposes, we proceed to conduct this portion of the economic substance analysis although the Tax Court did not do so explicitly. *See Northern Indiana Pub. Serv. Co.*, 115 F.3d at 510 (holding that court of appeals may affirm Tax Court decisions on any grounds found in the record regardless of Tax Court's rationale).

[34] The consideration consisted of $140 million in cash and LIBOR notes whose present value was $34,410,814, or $35,000,000, reduced by the transaction costs established by Merrill Lynch.

remaining 20%, or $35 million, to acquire an amount of LIBOR notes that was identical, apart from transaction costs, to the amount of such notes that ACM could have acquired by investing its $35 million in cash directly into such assets. Thus, the transactions with respect to the Citicorp notes left ACM in the same position it had occupied before engaging in the offsetting acquisition and disposition of those notes.

Just as the taxpayer in *Gregory* engaged in offsetting transactions by creating a new corporation, transferring stock to the corporation, transferring the stock back out of the corporation and then liquidating the corporation, just as the taxpayers in *Knetsch* and *Weller* engaged in offsetting transactions by acquiring annuity policies and borrowing back virtually their entire value, and just as the taxpayers in *Lerman* and the other property disposition cases engaged in inconsequential transactions by disposing of property while retaining the opportunity to reacquire the same or virtually identical property at the same price, so ACM engaged in mutually offsetting transactions by acquiring the Citicorp notes only to relinquish them a short time later under circumstances which assured that their principal value would remain unchanged and their interest yield would be virtually identical to the interest yield on the cash deposits which ACM used to acquire the Citicorp notes.[35]

Gregory requires us to determine the tax consequences of a series of transactions based on what "actually occurred." 293 U.S. at 469, 55 S.Ct. at 267. Just as the *Gregory* Court

---

[35] The variable rate on the Citicorp notes presented a theoretical possibility that the consequences of owning those notes would vary from the consequences of leaving ACM's funds on deposit at a rate of interest virtually identical to the initial rate on the Citicorp notes. However, ACM's exposure to any fluctuation in the rate of return on its Citicorp note investment was illusory, as the interest rates were scheduled to be reset only once per month and ACM had arranged to hold the notes for only 24 days, encompassing only one interest rate adjustment on November 15 that would affect the notes for only 12 days before their disposition. *See* 73 T.C.M. at 2200.

found that the intervening creation and dissolution of a corporation and transfer of stock thereto and therefrom was a "mere device which put on the form of a corporate reorganization as a disguise for concealing its real character" which amounts to a mere "transfer . . . of corporate shares to the [taxpayer]," so we find that ACM's intervening acquisition and disposition of the Citicorp notes was a mere device to create the appearance of a contingent installment sale despite the transaction's actual character as an investment of $35 million in cash into a roughly equivalent amount of LIBOR notes.[36] Thus, the acquisition and disposition of the qualifying private placement Citicorp notes, based upon which ACM characterized its transactions as a contingent installment sale subject to the ratable basis recovery rule, had no effect on ACM's net economic position or non-tax business interests and thus, as the Tax Court properly found, did not constitute an economically substantive transaction that may be respected for tax purposes. *See Gregory*, 293 U.S. at 469-70, 55 S.Ct. at 267-68; *Knetsch*, 364 U.S. at 366; *Lerman*, 939 F.2d 44; *Weller*, 270 F.3d at 297.[37]

---

[36] ACM emphasizes that the total consideration it was to receive in exchange for the Citicorp notes genuinely was contingent, in substance as well as in form, because the amount depended on a fluctuating market variable "precisely [as] the statute and the regulations anticipated." Br. at 31-32. However, the receipt of genuinely contingent payments is necessary but not sufficient to trigger the application of the ratable basis recovery rule which applies only in the context of a contingent installment sale. Absent an economically substantive disposition of qualifying property, the transactions do not constitute a bona fide contingent installment sale within the meaning of the provisions which ACM seeks to invoke. *See* I.R.C. §§ 453(b), 453(k); Temp. Treas. Reg. §15a.453-1(c).

[37] As discussed above, each of these cases involved objective acts which satisfied the technical requirements of the Internal Revenue Code provisions that the taxpayer sought to invoke, but which the courts disregarded for tax purposes because they lacked any net effect on the taxpayer's economic position or non-tax business interests. Accordingly, we are unpersuaded by ACM's argument that its transactions must be regarded as economically substantive because it actually and objectively engaged in them. *See* br. at 21.

ACM contends that the Tax Court was bound to respect the tax consequences of ACM's exchange of Citicorp notes for LIBOR notes because, under *Cottage Sav. Ass'n v. Commissioner*, 499 U.S. 554, 111 S.Ct. 1503 (1991), an exchange of property for "materially different" assets is a substantive disposition whose tax effects must be recognized. We find *Cottage Savings* inapposite. The taxpayer in that case, a savings and loan association, owned fixed-rate mortgages whose value had declined as interest rates had risen during the preceding decade. The taxpayer simultaneously sold those mortgages and purchased other mortgages which were approximately equal in fair market value, but far lower in face value, than the mortgages which the taxpayer relinquished. The Court found that the exchange for different mortgages of equivalent value afforded the taxpayer "legally distinct entitlements," and thus was a substantive disposition which entitled the taxpayer to deduct its losses resulting from the decline in value of the mortgages during the time that the taxpayer held them. *Id.* at 566, 111 S.Ct. at 1511.

The distinctions between the exchange at issue in this case and the exchange before the Court in *Cottage Savings* predominate over any superficial similarities between the two transactions. The taxpayer in *Cottage Savings* had an economically substantive investment in assets which it had acquired a number of years earlier in the course of its ordinary business operations and which had declined in actual economic value by over $2 million from approximately $6.9 million to approximately $4.5 million from the time of acquisition to the time of disposition. *See Cottage Sav.*, 499 U.S. at 557-58, 111 S.Ct. at 1506. The taxpayer's relinquishment of assets so altered in actual economic value over the course of a long-term investment stands in stark contrast to ACM's relinquishment of assets that it had acquired 24 days earlier under circumstances which assured that their principal value would remain constant

and that their interest payments would not vary materially from those generated by ACM's cash deposits.[38]

While the dispositions in *Cottage Savings* and in this case appear similar in that the taxpayer exchanged the assets for other assets with the same net present value, beneath this similarity lies the more fundamental distinction that the disposition in Cottage Savings precipitated the realization of actual economic losses arising from a long-term, economically significant investment, while the disposition in this case was without economic effect as it merely terminated a fleeting and economically inconsequential investment, effectively returning ACM to the same economic position it had occupied before the notes' acquisition 24 days earlier.[39]

As the Supreme Court emphasized in *Cottage Savings*, deductions are allowable only where the taxpayer has sustained a "'bona fide'" loss as determined by its "'[s]ubstance and not mere form.'" 499 U.S. at 567-68, 111

---

[38] In *Lerman*, 939 F.2d at 55-56 & n.14, we observed that *Cottage Savings* involved the relinquishment of assets whose value had declined by over $2 million. Because the transaction in *Cottage Savings* brought about the realization of a $2 million economic loss resulting from the disposition of depreciated assets in which the taxpayer had an economically substantive investment, we reject ACM's contention, *see* reply br. at 15, that the case recognized as an economically substantive loss any tax loss arising from a transaction in which the taxpayer disposes of property in an arms'-length transaction. The *Cottage Savings* Court had no occasion to address a transaction like that before us in which the taxpayer relinquished property after a minimal holding period with no intervening change in economic value.

[39] ACM contends that its disposition of the Citicorp notes was substantive because it "relinquished the benefits and burdens of owning the Citicorp notes for the distinct benefits and burdens of owning $140 million of cash and the LIBOR notes." Br. at 28. This argument, however, erroneously assumes that ACM had acquired the benefits and burdens associated with the Citicorp notes in an economically substantive sense, when in reality ACM's brief investment in and offsetting divestment from these assets exposed ACM only to *de minimis* risk of changes in principal value or interest rates.

S.Ct. at 1511 (quoting Treas. Reg. §1.165-l(b)). According to ACM's own synopsis of the transactions, the contingent installment exchange would not generate actual economic losses. Rather, ACM would sell the Citicorp notes for the same price at which they were acquired, *see* app. at 275-77, 321, 300, generating only tax losses which offset precisely the tax gains reported earlier in the transaction with no net loss or gain from the disposition. *See* app. at 301.[40] Tax losses such as these, which are purely an artifact of tax accounting methods and which do not correspond to any actual economic losses, do not constitute the type of "bona fide" losses that are deductible under the Internal Revenue Code and regulations.

While ACM contends that "it would be absurd to conclude that the application of the Commissioner's own [ratable basis recovery] regulations results in gains or losses that the Commissioner can then deem to be other than 'bona fide,'" reply br. at 14, its argument confounds a tax accounting regulation which merely prescribes a method for reporting otherwise existing deductible losses that are realized over several years with a substantive deductibility provision authorizing the deduction of certain losses. In order to be deductible, a loss must reflect actual economic consequences sustained in an economically substantive transaction and cannot result solely from the application of a tax accounting rule to bifurcate a loss component of a transaction from its offsetting gain component to generate an artificial loss which, as the Tax Court found, is "not economically inherent in" the transaction. 73 T.C.M. at 2215.[41] Based on our review of the

---

[40] The participation of a foreign partner that was impervious to tax considerations and that claimed most of the reported gains while allocating to Colgate virtually all of the losses allowed Colgate as ACM's major U.S. partner to reap the benefits of the tax losses without sustaining the burdens of the offsetting tax gains.

[41] Because the ratable basis recovery rule simply provides a method for reporting otherwise existing economically substantive losses, we find it irrelevant that the rule recognizes that its application could "inappropriately defer or accelerate recovery of the taxpayer's basis,"

record regarding the objective economic consequences of ACM's short-swing, offsetting investment in and divestment from the Citicorp notes, we find ample support for the Tax Court's determination that ACM's transactions generated only "phantom losses" which cannot form the basis of a capital loss deduction under the Internal Revenue Code.[42]

3. *Subjective Aspects of the Economic Sham Analysis*

In making its determination that it did "not find any economic substance" in ACM's transactions, the Tax Court relied extensively on evidence that the transactions were not intended to serve any "useful non-tax purpose" and were not reasonably expected to generate a pre-tax profit. *See* 73 T.C.M. at 2215, 2229. ACM contends, br. at 34, that the Tax Court improperly conducted a "generic tax-independent" inquiry into the non-tax purposes and potential pre-tax profitability of the transaction based on a misapplication of *Gregory*, 293 U.S. at 469, 55 S.Ct. at 267. According to ACM, the Tax Court mistook *Gregory's* scrutiny of the "business or corporate purpose" behind the transaction for a universally applicable aspect of the economic substance

---

resulting in "'substantial distortion'" of the tax consequences realized in any particular year of a transaction. *See* ACM br. at 32-34 (quoting Temp. Treas. Reg. §§15a.453-1(c)(3), (c)(7)). While the rule contemplates some distortion as to the timing of when actual gains or losses are reported over the span of a contingent installment sale, it does not contemplate the reporting of losses which are not the bona fide result of an economically substantive transaction. Thus, contrary to ACM's argument, the tax losses it reported are not "precisely what the [regulations] intended." *See* br. at 33.

[42] Having found ample support for the Tax Court's conclusion that ACM's transactions lacked economic substance and thus cannot give rise to taxable gains or deductible losses regardless of how those gains and losses are allocated, we need not address the Commissioner's alternative argument that the tax consequences of the transaction must be disregarded because ACM's partnership structure artificially "bifurcat[ed] the tax consequences of the transaction" by allocating taxable gains to a foreign partner and offsetting tax losses to the taxpayer in a manner which the relevant statute and regulations did not intend. *See* br. at 32-34.

analysis when in reality, ACM contends, *Gregory* undertook this inquiry only because the specific Internal Revenue Code provision there at issue required that the transaction be effected "pursuant to a plan of reorganization." *See* br. at 20-23 (citing *Gregory*, 293 U.S. at 469, 55 S.Ct. at 267). Thus, ACM argues, the Tax Court erred in considering the intended purpose and expected profitability of the transactions in this case where the relevant provisions providing for the gain or loss on sales or exchanges of property, I.R.C. § 1001, and for the treatment of installment sales, I.R.C. § 453, do not require a particular business purpose or profit motive. *See id.*

We disagree, and find that the Tax Court's analysis properly rested on economic substance cases applying provisions which, like those relevant in this case, do not by their terms require a business purpose or profit motive. In *Goldstein v. Commissioner*, 364 F.2d 734, 736 (2d Cir. 1966), the court analyzed the economic substance of a transaction under I.R.C. §163(a), which provides, in purely objective terms without reference to a business purpose or profit motive, that "[t]here shall be allowed as a deduction all interest paid or accrued within a taxable year on indebtedness." The *Goldstein* court acknowledged that this broad language did not require "that the deductible interest serve a business purpose, that it be ordinary and necessary, or even that it be reasonable," but found that the language did not permit deductions arising from a transaction that had "no substance or purpose aside from the taxpayer's desire to obtain the tax benefit of an interest deduction." *Id.* at 741-42. Thus, the court found, the taxpayer was not entitled to deduct her substantial interest charges, although they had accrued in an arms'-length transaction, because she had incurred the underlying debt for the sole purpose of generating a tax deduction to offset other income.[43]

---

[43] ACM seeks to distinguish *Goldstein* on the grounds that it involved a transaction which lacked objective economic effect because "economically, [the taxpayer's] activities netted zero." However, contrary

Likewise, in *Wexler*, 31 F.3d 117, we considered and rejected the taxpayer's argument that a transaction need not further any non-tax objectives or hold any profit potential where the governing statutory provisions do not "require that the deductions they provide for arise from transactions having a business purpose or profit motive." *Id.* at 122. Despite the broad statutory language allowing the deduction of "all interest paid or accrued . . . on indebtedness," I.R.C. §163(a), we concluded that interest charges were not deductible if they arose from a transaction "entered into without expectation of economic profit and [with] no purpose beyond creating tax deductions." *Id.* at 123-24 (citations omitted). We emphasized that interest payments "are not deductible where the underlying transaction has no purpose other than tax avoidance" even if the governing statutory language "had no express business-purpose requirement." *Id.* at 124 (citations omitted).[44] Thus, we find no

---

to ACM's contention that it "bore all of the benefits and burdens of the ownership of . . . the Citicorp Notes and then the cash and LIBOR Notes, and stood to recognize true economic gain or loss from holding those assets," reply br. at 5-6, we find that the critical parts of ACM's transactions also "netted zero" because its acquisition and offsetting disposition of the Citicorp notes had no net effect on its economic position. Thus, we reject ACM's attempt to distinguish *Goldstein* which, like the Tax Court opinion in this case, analyzed the taxpayer's intended purposes as well as the transaction's economic effects.

[44] Because the intended purposes behind a transaction are relevant in assessing its economic substance even where the statute is drafted in broad terms that do not require a particular intent or purpose, we are unpersuaded by ACM's argument that its transactions must be respected as economically substantive because I.R.C. § 1001, which provides for the recognition of gain or loss "on the sale or exchange of property" was intended to encompass "all exchanges." *See* br. at 23-25 (citing H.R. Rep. No. 179, 68th Cong., 1st Sess., at 13 (1924)). ACM emphasizes, br. at 25-27, that the Supreme Court in *Cottage Savings*, 499 U.S. 554, 111 S.Ct. at 1503, recognized the tax effects of a disposition that was motivated solely by tax considerations and was not expected to generate a pre-tax profit. As discussed above, however, the transaction in *Cottage Savings* had objective economic substance because it resulted in the realization of actual economic losses arising from a $2 million decline in market value of the property exchanged. Where such objective economic effects are

merit in ACM's argument that the Tax Court erred as a matter of law by scrutinizing the asserted business purposes and profit motives behind ACM's transactions, and we turn to the question of whether the court erred in finding that the transactions were not intended to serve ACM's professed non-tax purposes and were not reasonably expected to generate a pre-tax profit.

4. *Intended Purposes and Anticipated Profitability of ACM's Transactions*

Before the Tax Court, ACM conceded that there were tax objectives behind its transactions but contended that "tax-independent considerations informed and justified each step of the strategy." 73 T.C.M. at 2217. ACM asserted that its transactions, in addition to presenting "a realistic prospect that ACM would have made a profit" on a pre-tax basis, also served the tax-independent purposes of providing an interim investment until ACM needed its cash to acquire Colgate debt and a hedge against interest rate risk within the partnership. The Tax Court, however, found that the record did not support ACM's assertions that the transactions were designed either to serve these non-tax objectives or to generate a pre-tax profit, *see* 73 T.C.M. at 2217-29, and for the following reasons, we agree.

a. Interim Investment

ACM contends that it invested in the Citicorp notes not only because they qualified for treatment under the contingent installment sale provisions and the ratable basis recovery rule, but also because they served as an appropriate interim investment until ACM could invest in the Colgate debt whose acquisition, according to ACM, was a central objective of the

---

lacking, scrutiny of the subjective intent behind the transactions becomes an important means of determining whether the transactions constitute a scheme with "no purpose other than tax avoidance" that may not give rise to deductible losses even where the statute contains no express requirement that the transaction serve a non-tax business purpose. *Wexler*, 31 F.3d at 124.

partnership. The Tax Court, however, rejected this contention on the grounds that ACM did not acquire the Citicorp notes as an interim investment "to accommodate the timing of the acquisition of Colgate debt; rather, it was the reverse: The acquisition of the Colgate debt was timed so as to accommodate the requirements of the section 453 investment strategy" which required ACM to acquire and dispose of private placement notes. 73 T.C.M. at 2227. This conclusion finds abundant support in the record.

In May 1989, Merrill Lynch presented Colgate with an initial proposal of partnership transactions intended to generate capital losses which Colgate could use to offset 1988 capital gains. Although Merrill Lynch had not yet incorporated the concept of using the partnership to acquire Colgate debt issues as it did in its subsequent July 28 and August 17 proposals, its May proposal nonetheless contemplated the acquisition and imminent disposition of short-term securities, with no intervening change in their economic value, in exchange for contingent installment notes. *See* 73 T.C.M. at 2191; app. at 678-79, 275-77. The fact that the acquisition and disposition of short-term notes were central parts of the proposed partnership transactions even before the formulation of non-tax partnership objectives belies ACM's contention that its contingent installment exchange of Citicorp notes was designed to accommodate the timing of its debt acquisition strategy.

Moreover, as early as October 3, 1989, one month before ACM was formed, Pohlschroeder reported that he had identified the Met notes as targets for acquisition and that, "pursuant to an inquiry to Metropolitan, we feel confident that the partnership can purchase sufficient Colgate debt" to serve the partnership's objectives. App. at 314. Yet, despite this confidence that the debt was available for purchase well in advance of ACM's formation, Pohlschroeder did not recommend that the partnership invest its funds directly in the identified debt issues or finalize the terms of the anticipated

debt purpose, but rather identified as the "Next Steps" after formation of the partnership "Short-term investment securities acquired.... Disposition of short term investment securities to fund acquisition of Colgate debt." App. at 321. In accordance with this plan, ACM did not take any measures to pursue the prompt purchase of these debt issues upon its receipt of $205 million in cash contributions on November 2, 1989, but rather, acting through Colgate, instructed Metropolitan to attend a November 17 meeting to discuss the terms of the sale. *See* 73 T.C.M. at 2227.[45] Thus, we agree with the Tax Court's finding that any delay preceding the opportunity to acquire Colgate debt was of ACM's own deliberate making and was intended so that ACM could engage in the tax-motivated acquisition and disposition of qualifying short-term notes in the contingent installment sale that had been contemplated since before Merrill Lynch and Colgate devised the concept of incorporating debt acquisition objectives into Merrill Lynch's initial tax reduction proposal.

Even if ACM had faced a delay before it could purchase Colgate debt and thus needed to locate a suitable interim investment, the *Citicorp* notes ill served the professed purpose of holding cash assets in anticipation of an impending purchase. The notes, which in order to qualify for treatment in a contingent installment sale could not be traded on an established market, *see* I.R.C. §453(k)(2)(A), were highly illiquid and thus could not be converted back into the cash needed to purchase Colgate debt without significant transaction costs in the form of the bid-ask spread which Merrill Lynch deemed necessary to market the notes to third

---

[45] Pohlschroeder's handwritten memorandum of October 19 indicating that the Met Note acquisition would proceed on November 17 and that the Long Bond and Euro Note acquisitions would proceed after acquisition of the Citicorp notes further supports the Tax Court's determination that ACM delayed the acquisition of the debt issues to accommodate its tax-driven strategy of acquiring and disposing of private placement notes in a contingent installment sale. *See* 73 T.C.M. at 2200.

parties. These transaction costs rendered the illiquid Citicorp notes paying 8.78% significantly less advantageous as an interim investment than the fully liquid cash deposit account paying 8.75%. Accordingly, we find no error in the Tax Court's conclusion that ACM's brief investment in the Citicorp notes was motivated by the pursuit of the tax advantages of a contingent installment sale rather than by a need for an interim investment pending its acquisition of Colgate debt. *See* 73 T.C.M. at 2227-29.

b. Hedge Against Interest Rate Risk

The Tax Court also rejected ACM's contention that it invested in LIBOR notes not only because they generated the contingent payments necessary to trigger the application of the ratable basis recovery rule, but also because they were an appropriate hedge against the interest rate exposure brought about by ACM's investment in Colgate debt issues. As the court explained, ACM's asserted rationale of hedging against other assets within the partnership would "defeat [the] very purpose" which Colgate had advanced for pursuing a debt acquisition partnership in the first instance. 73 T.C.M. at 2222. The court accurately noted that Colgate had entered into the partnership based on a prediction of falling interest rates and had justified its plan to acquire fixed-rate Colgate debt issues on the grounds that as interest rates declined, these issues would appreciate in value to ACM as the obligee, thus offsetting, through Colgate's share in ACM, the increased burdens that Colgate effectively would sustain as the obligor on those instruments if market interest rates fell further below the fixed rate established on these obligations. *See* 73 T.C.M. at 2192-93, 2221-25; app. at 311, 666-68, 880-82, 2762-63, 2765, 2769-70.

While the acquisition of Colgate debt furthered this professed goal of decreasing the exposure associated with Colgate's fixed rate long term debt structure outside of the partnership, the acquisition of the LIBOR notes, whose value

would decline as interest rates declined, conversely increased ACM's exposure to falling interest rates, offsetting the desired effect of the debt acquisition program which purportedly was a fundamental partnership objective. *See* T.C.M. at 2221; app. at 311. Accordingly, the LIBOR notes, by hedging against the Colgate debt issues acquired within the partnership, negated the potential benefit of ACM's acquisition of these issues as a hedge against Colgate's interest rate exposure outside the partnership.

The fact that the interest rate exposure resulting from the LIBOR notes undermined rather than furthered the partnership's purported debt management objectives is also evident from the fact that Colgate reserved the option under the partnership agreement to elect to increase its share in changes in the value of the Colgate debt issues attributable to fluctuations in market interest rates, and exercised this option on several occasions. *See* app. at 101. Because the value of the fixed-rate Colgate debt issues increased in inverse proportion to interest rates, Colgate's exercise of this option reflects a prediction of falling interest rates which would result in risk to Colgate through its liabilities outside the partnership but would benefit Colgate through its interest in the assets held within the partnership. The acquisition of LIBOR notes, whose value depended in direct proportion on interest rates, effectively would dilute the benefits which the partnership was intended to yield and which Colgate sought to maximize by exercising its options under the partnership agreement. Thus, we find considerable support in the record for the Tax Court's conclusion that the acquisition of the LIBOR notes operated to "defeat [the] very purpose" which ACM had advanced as a tax-independent justification for its sequence of investments.

Although ACM meticulously set forth, in contemporaneously recorded documents, tax-independent rationales for each of its transactions with respect to the

Citicorp notes and LIBOR notes,[46] these stated rationales cannot withstand scrutiny in light of the stated purposes behind the partnership itself, because the investment in the Citicorp notes impeded rather than advanced ACM's professed goal of making its cash available to acquire Colgate debt issues, just as the investment in the LIBOR notes impeded rather than advanced the professed goal of acquiring partnership assets that would hedge against Colgate's exposure to declining interest rates outside the partnership.[47] Accordingly, we find no error in the Tax Court's determination that the transactions "served no useful non-tax purpose," 73 T.C.M. at 2229, and thus constituted the type of scheme with "no purpose other than tax avoidance" that lacks the economic substance necessary to give rise to a deductible loss. *Wexler*, 31 F.3d at 124.[48]

---

[46] *See* app. at 386-87 (authorizing investment in "private placement" notes as an investment "pending the acquisition" of Colgate debt issues); app. at 391 (recommending sale of Citicorp notes to generate cash needed to acquire Colgate debt and acquisition of LIBOR notes to hedge risks associated with Colgate debt); app. at 397 (advising reduction of LIBOR note holdings in light of reduced need for hedging within partnership); app. at 408-09 (recommending disposition of remaining "highly volatile" LIBOR notes in light of Colgate's increased partnership interest which eliminated need for hedge within partnership).

[47] The rationales set forth in ACM's contemporaneous records are particularly implausible in light of the documents prepared between May and October 1989, before ACM's formation, which propose an identical sequence of transactions far in advance of the events which, according to memoranda and minutes recorded during the operation of the partnership, prompted each ensuing step in the series of transactions. *See* 71 T.C.M. at 2191; app. at 678-79, 275-79, 310-21, 296-308.

[48] While ACM purported to combine the tax avoidance objectives of Merrill Lynch's initial May 1989 proposal with the non-tax debt acquisition objectives incorporated into subsequent proposals, ACM's pursuit of these two distinct objectives within the same partnership cannot obscure the fact that the contingent installment exchange, which was solely responsible for the tax consequences at issue, was executed independently of, did not further, and in fact impeded ACM's pursuit of its non-tax debt acquisition objectives, because the Citicorp notes placed the

c. Anticipated Profitability

In addition to rejecting ACM's asserted non-tax justifications for its sequence of investments and dispositions, the Tax Court also rejected ACM's contention that its transactions were reasonably expected to yield a pre-tax profit because the court found ACM had planned and executed its transactions without regard to their pretax economic consequences. *See* 73 T.C.M. at 2217-21. The evidence in the record overwhelmingly supports this conclusion.[49] The documents outlining the proposed transactions, while quite detailed in their explication of expected tax consequences, are devoid of such detailed projections as to the expected rate of return on the private placement notes and contingent payment notes that were essential components of each proposal. See 73 T.C.M. at 2191; app. at 678-79, 263-79, 296-308.[50]

---

cash needed to acquire Colgate debt into illiquid instruments whose disposition cost ACM several million dollars in transaction costs while the purchase of the LIBOR notes increased exposure to falling interest rates, diminishing the desired effects of the debt acquisition strategy. Thus, the non-tax motivations behind ACM's debt purchase do not alter the fact that the contingent installment sale was motivated only by tax avoidance purposes.

[49] ACM, citing *Sacks v. Commissioner*, 69 F.3d 982, 991 (9th Cir. 1995), argues that a transaction need not be profitable in order to be respected for tax purposes. *See* br. at 24 & n.30. *Sacks*, however, held that, [w]here a transaction has economic substance, it does not become a sham merely because it is likely to be unprofitable on a pre-tax basis," and found that the transaction had economic substance because it involved a sale and leaseback of equipment used for legitimate business purposes and it resulted in concrete changes in the parties' economic positions. *See* 69 F.3d at 990-92. Thus, *Sacks* is inapposite in this case where the contingent installment exchange served no non-tax business purposes and did not materially alter ACM's economic position.

[50] According to these documents, the capital gains realized in the first year of the transaction would equal the aggregate capital losses realized in the ensuing years, reflecting no net economic change. *See* app. at 279, 300-301, 305-08

Moreover, ACM's partners were aware before they entered the partnership that the planned sequence of investments would entail over $3 million in transaction costs. *See* app. at 294. Yet Colgate, which effectively bore virtually all of these costs pursuant to the terms of the partnership agreement, did not attempt to assess whether the transactions would be profitable after accounting for these significant transaction costs. *See* 73 T.C.M. at 2217-18, 2204. Furthermore, while ACM planned to dispose of the Citicorp notes after a brief holding period for an amount equal to their purchase price, *see* app. at 275-77, 300, 321, its proposed transactions contemplated holding for two years the LIBOR notes whose principal value would decline in the event of the falling interest rates which ACM's partners predicted. *See* app. at 311, 753-55.

Thus, while the Citicorp note investment which was essential to structuring the transaction as a contingent installment sale was economically inconsequential, the LIBOR note investment which was equally essential to achieving the desired tax structure was economically disadvantageous under the market conditions which Colgate predicted and which actually transpired. ACM's lack of regard for the relative costs and benefits of the contemplated transaction and its failure to conduct a contemporaneous profitability analysis support the Tax Court's conclusion that ACM's transactions were not designed or reasonably anticipated to yield a pre-tax profit, particularly in view of the significant transactions costs involved in exchanging illiquid private placement instruments. *See Hines v. United States*, 912 F.2d 736, 739 (4th Cir. 1990).[51]

---

[51] ACM, citing its expert's opinion that ACM could have earned a profit at market interest rates of 8%, *see* br. at 38 & n.47, contends that the Tax Court erred in concluding that ACM could not have expected to earn a profit from its transactions "under any reasonable forecast of future interest rates." 73 T.C.M. at 2219. However, in assessing the anticipated profitability of a transaction, tax courts properly may disregard computations, such as those presented by ACM's expert, that were

In light of the Tax Court's well-founded conclusion that Colgate and ACM expected interest rates to decline, rendering the proposed transactions unprofitable, we find it immaterial whether, as ACM contends, the court overstated the degree to which interest rates would have had to rise in order for ACM to recover its transaction costs. *See* br. at 42-43. Even accepting ACM's assertion that it could have recovered its costs upon a significantly smaller rise in interest rates than that calculated by the Tax Court, this assertion is immaterial in the event of falling interest rates and at best demonstrates a prospect of a nominal, incidental pre-tax profit which would not support a finding that the transaction was designed to serve a non-tax profit motive. *See Sheldon v. Commissioner*, 94 T.C. 738, 768 (1990).[52]

Furthermore, we find no merit in ACM's assertion that the Tax Court improperly based its determination that the

---

prepared in the context of the litigation and which "had not entered into [the taxpayer's] calculations at the outset" of the transaction. *Goldstein*, 364 F.2d at 740. Because nothing in the record resembles a profitability calculation conducted at the inception of the transaction, we find no error in the Tax Court's determination that ACM's transactions were not designed to generate a profit.

[52] Similarly, the evidence that neither Colgate nor ACM reasonably expected to gain any pretax profit from the transaction or even attempted to formulate a profitability projection compels us to reject ACM's contention that the Tax Court's profitability analysis improperly rested on a finding that ACM could have made greater profits with less risk by pursuing alternative investments. *See* br. at 46. While *Lemmen v. Commissioner*, 77 T.C. 1326, 1346 n.29 (1981), on which ACM relies, emphasized that a business venture may constitute an activity engaged in for profit within the meaning of I.R.C. § 183 even when other types of ventures may have been more profitable, this proposition does not preclude the Tax Court from considering, in its analysis of whether there was a profit move behind ACM's transactions, that the decision to exchange Citicorp notes for LIBOR notes involved substantial transaction costs, entailed significant risks given the anticipated falling interest rates, and compared unfavorably to the higher profitability and lower risk of the 8.75% cash deposit accounts which ACM affirmatively relinquished to pursue this strategy.

transactions were unprofitable for Colgate on the erroneous assumption that Colgate, directly and through Southampton, "would continue to own only 17 percent of ACM's assets," causing it to understate the profits Colgate would receive toward the end of the transactions when it would own 99.7% of the partnership. *See* br. at 39.[53] As discussed above, however, neither ACM nor any of its partners reasonably anticipated any profits resulting from the relevant transactions, which entailed an economically inconsequential investment in Citicorp notes and a decidedly unprofitable investment in LIBOR notes whose value would be expected to decline under contemporaneously predicted market conditions. Because the contingent installment exchange transaction, as contemplated and as actually executed, yielded no partnership profits in any amount, Colgate's percentage share of those non-existent profits is immaterial.[54]

---

[53] ACM contends that the Tax Court erred by examining the transactions' anticipated profitability from Colgate's perspective, contrary to the principle that the expected profitability of partnership transactions must be determined "at the partnership level, rather than at the level of the partners." Br. at 36. However, as we explained in *Simon v. Commissioner*, 830 F.2d 499, 507 (3d Cir. 1987),

> [a]lthough the existence of a profit objective of a partnership is determined at the partnership level, . . . a partnership is merely a formal entity, and a determination of profit objective can only be made with reference to the actions of those . . . who manage the partnership affairs . . . . . [Therefore] the Tax Court did not misapply the profit objective test at the partnership level by looking to the motives and actions of those individuals that organized, structured and conducted [partnership] operations.

In this case where ACM and its transactions were structured around Colgate's objectives and where Colgate was to hold a 99.7% stake in any eventual partnership profits, *see* 73 T.C.M. at 2190-97, 2217-19, 2221, we find no error in the Tax Court's examination of Colgate's prospects for profit as a means of analyzing ACM's prospects for profit.

[54] ACM argues, br. at 9, that each of ACM's partners realized a positive pre-tax return on its investment in ACM. However, we reject ACM's attempt to equate net partnership profits with profits resulting

Even assuming, however, that ACM and its partners expected to earn some measure of profits upon disposition of the BOT LIBOR notes, any additional portion of these profits that would redound to Colgate's benefit due to its increased share in the partnership cannot be characterized as an additional return on Colgate's investment in partnership assets because Colgate, directly and through Southampton, paid well over $100 million to acquire its increased partnership interest. *See* app. at 137, 769-70.[55] These additional contributions far exceeded Colgate's initial partnership investment of $35 million, undermining ACM's assertion that any additional returns attributable to Colgate's increased stake in the partnership properly may be characterized as further returns on Colgate's interest in the partnership's investments. Thus, we are unpersuaded by ACM's contention that the Tax Court distorted its profitability analysis by failing to account for Colgate's increased partnership interest.

ACM also argues that the Tax Court's profitability analysis was flawed because the court adjusted the income expected to be generated by the LIBOR notes to its net present value. *See* br. at 43. In support of its assertion that this net present value adjustment constitutes reversible error, ACM cites *Estate of Thomas v. Commissioner*, 84 T.C. 412 (1985), which noted that the issue of present value adjustments was "not raised or briefed by the parties" and held that absent some statutory guidance, it would not

---

from the contingent installment exchange which gave rise to the tax consequences at issue and which the Tax Court properly found, based on ample evidence in the record, was not reasonably anticipated to generate a profit. *See* 73 T.C.M. at 2218-19.

[55] On June 25, 1991, Colgate paid Kannex $85,897,203 and Southampton paid Kannex $15 million to purchase a portion of Kannex's share in the partnership. On November 27, 1991, ACM redeemed Kannex's remaining partnership interest at a cost of $100,775,915 which Colgate borrowed against the partnership assets it was to acquire. *See* app. at 137, 769-70.

discount the residual value of obsolete partnership assets at the time of obsolescence to their equivalent present values at the time the partnership was formed. The court reasoned that discounting to present value effectively would require that the taxpayer's investment yield a rate of return exceeding the discount rate which, the court found, would contravene the admonition in Treas. Reg. § 1.183-2(b)(9) that "the availability of other investments which would yield a higher return, or which would be more likely to be profitable, is not evidence that an activity is not engaged in for profit" within the meaning of I.R.C. § 183. *See* 84 T.C. at 440 n.52.

We reject ACM's contention that *Estate of Thomas*, which construed Treasury Regulations under I.R.C. § 183, precludes present value adjustments in the prospect-for-profit analysis under the judicially created economic substance doctrine.[56] In transactions that are designed to yield deferred rather than immediate returns, present value adjustments are, as the courts have recognized, an appropriate means of assessing the transaction's actual and anticipated economic effects. *See, e.g., Hilton v. Commissioner*, 671 F.2d 316, 317 (9th Cir. 1982) (affirming economic substance determination based on present value analysis of taxpayer's investments); *Citizens & Southern Corp. v. Commissioner*, 91 T.C. 463, 498 (1988) (noting that value of an acquired asset may be determined based on future income likely to be generated that by that asset discounted to

---

[56] ACM also cites *City of New York v. Commissioner*, 103 T.C. 481, 487 (1994), aff'd, 70 F.3d 142 (D.C. Cir. 1995), which analyzed whether I.R.C. § 141, in setting forth statutory distinctions based on the amount of bond proceeds forwarded to private parties, referred to these amounts in absolute terms or as adjusted to present value. The court concluded that "time value of money concepts can be applied only in the presence of a legislative directive to do so" and found no indication that Congress intended to refer to adjusted amounts. *Id.* (citation omitted). Because the issue of whether to imply a net present value adjustment in an amount specified in the Internal Revenue Code is distinct from the issue of whether to consider net present value as a variable in a profitability analysis under the economic substance doctrine, we find *City of New York* inapposite.

present value), *aff'd*, 919 F.2d 1992 (11th Cir. 1990); *Gianaris v. Commissioner*, 64 T.C.M. (CCH) 1229, 1234 (1992) ("we have consistently discounted. . . income streams produced by [an investment] in determining whether the taxpayer had a profit objective") (citations omitted).

We find no basis in the law for precluding a tax court's reliance on a present value adjustment where such an adjustment, under the surrounding circumstances, will serve as an accurate gauge of the reasonably expected economic consequences of the transaction. In this case where ACM's transactions essentially converted readily available cash, with only a brief interim investment in the Citicorp notes, into a stream of deferred payments, we find that the present value adjustment played an appropriate role in the Tax Court's analysis of the potential profitability of the transactions. We accordingly find no error in this aspect of the court's analysis.

ACM also avers that the Tax Court erred in excluding from its profitability analysis "the pre-tax income resulting from the investment of $140 million of cash received as part of the consideration for the Citicorp Notes." Br. at 44. We disagree. The Tax Court properly analyzed the profitability of the transactions whose economic substance is at issue, namely the contingent installment exchange of Citicorp notes for LIBOR notes which gave rise to the disputed tax consequences. Any profits arising from ACM's investment of $140 million in cash into Colgate debt issues did not result from the contingent installment exchange whose economic substance is in issue. Because this sum of cash in fact represents the portion of the proceeds from the Citicorp notes which ACM did *not* invest in the contingent installment exchange of the other $35 million in Citicorp notes for contingent-payment LIBOR notes, any profits derived from these funds cannot be characterized as profits arising from the contingent installment exchange. Thus, the Tax Court properly excluded these profits from its analysis of the profitability of the contingent installment sale which gave rise

to the disputed capital losses.[57] We find ample support in the record for the Tax Court's conclusion that ACM and its partners did not reasonably anticipate that its contingent installment sale would generate a pre-tax profit. Because ACM's acquisition and disposition of the Citicorp notes in a contingent installment exchange was without objective effect on ACM's net economic position or non-tax objectives, and because its investments in the Citicorp notes and LIBOR notes did not rationally serve ACM's professed non-tax

---

[57] For similar reasons, we reject ACM s contention, *see* br. at 45, that the Tax Court erroneously excluded from its profitability analysis the gains derived from the portion of the Citicorp notes which ACM held until October 1991 instead of exchanging them for LIBOR notes. These notes, like the $140 million cash proceeds of the Citicorp note disposition, were not involved in the exchange for contingent-payment notes. Thus, any profits generated thereby may not be considered to be profits arising from the contingent installment sale. In fact, the profitability of holding the Citicorp notes until 1991 when they could be tendered to the issuer at par, ensuring recovery of their principal value, only highlights the lack of reasonably anticipated profitability in exchanging these notes for the LIBOR notes whose principal value was at risk in the projected declining interest rate market. We also are unpersuaded by ACM's contention, *see id.*, that the Tax Court, having excluded from its profitability analysis the gains from the Citicorp notes held until 1991, erred by failing to exclude from its calculations a portion of the transaction costs arising from the partnership transactions as a whole. *See id.* Even if we were to subtract the 15% pro rata portion of the transaction costs that ACM suggests were attributable to the 15% of ACM's $205 million in Citicorp notes which were not exchanged in the contingent sale, the resulting increase in the net yield from ACM's transactions, totaling under $0.5 million, would not support the conclusion that these transactions portended a reasonable prospect for profit, particularly in light of the evidence that ACM and its partners made no attempt to assess the transactions' profitability after transaction costs. In any event, the Tax Court properly declined to allocate a pro rata portion of the overall transaction costs to the portion of the Citicorp notes which were put to Citicorp at par in 1991, because the most significant portion of the transaction costs arose in the course of negotiating the structured transaction and bid-ask spread required to market the illiquid private placement notes to third parties in the contingent installment exchange and to remarket the LIBOR notes, and thus was not properly attributable to the notes which ACM retained and put to Citicorp in 1991.

objectives or afford ACM or its partners a reasonable prospect for pre-tax profit, we will affirm the Tax Court's determination that the contingent installment exchange transactions lacked economic substance and its resulting decision providing that the capital gain and loss at issue will not be recognized and thus disallowing deductions arising from the application of the contingent installment sale provisions and the ratable basis recovery rule.

B. Actual Economic Losses

Following the entry of the Tax Court's opinion holding that ACM's contingent installment sale did not have sufficient economic substance to be recognized for tax purposes, the parties submitted memoranda pursuant to Tax Court Rule 155 regarding the proper computation of tax liabilities to be allocated by ACM pursuant to that opinion. ACM argued that even if it was not entitled to deduct the entire $84,997,111 in tax losses it had reported, it was entitled to deduct the approximately $6 million "portion of its loss that is not attributable to the installment sale accounting and that reflects the actual economics of the transactions in issue." App. at 3386; *see* also app. at 3348-51, 3385-98. The court rejected ACM's argument and entered a final decision disallowing all deductions arising from ACM's transactions as well as the 1989 capital gain. *See* app. at 3444. ACM contends that the Tax Court erroneously failed to recognize that ACM's ownership of the LIBOR notes had economic substance even if the contingent installment sale did not, and thus improperly disallowed deductions arising from its ownership of those notes, resulting in inconsistent tax treatment in light of ACM's reporting of the income generated by those notes.[58] We agree.

---

[58] Contrary to the Commissioner's suggestion, br. at 49, ACM adequately raised before the Tax Court its contention that, as gain from the LIBOR notes was recognized, it was entitled to deduct the corresponding economic losses on those notes. *See* app. at 3386 ("[d]isallowing the loss

In *Lerman*, 939 F.2d at 45, we held that a transaction that lacks economic substance "simply is not recognized for federal taxation purposes, for better or for worse," and we are not aware of any cases applying the economic substance doctrine selectively to recognize the consequences of a taxpayer's actions for some tax purposes but not others. Rather, the courts have applied economic substance principles to "give effect either to both the cost and the income functions [of a transaction], or to neither." *Seykota v. Commissioner*, 62 T.C.M. (CCH) 1116, 1118 (1991); *accord Sheldon*, 94 T.C. at 762 (denying interest deduction and accordingly holding that income items should not be recognized); *Arrowhead Mountain Getaway, Ltd. v. Commissioner*, 69 T.C.M. (CCH) 1805, 1822 (1995) (holding that because transactions were economic shams that could not give rise to deductions, amounts received in the course of those transactions could not be characterized as taxable income), *aff'd*, 119 F.3d 80 (9th Cir. 1997) (table). Thus, we must set aside the Tax Court's decision to the extent that it disallowed the deduction of all losses, including actual economic losses, associated with the LIBOR notes without adjusting for the taxes paid on the approximately $2.3 million of interest income generated by the same notes. *See* app. at 3444, 3390.

While it is clear that the income and loss aspects of the LIBOR notes must be treated consistently with one another, this proposition does not resolve whether the consistency should be achieved by disregarding the tax consequences of the income generated by the notes or by permitting the deduction of actual economic losses associated with the notes. ACM urges us to adopt the latter position and in support thereof invokes *Wexler*, 31 F.3d at 127, in which we held that "in some circumstances, a sham transaction may have separable, economically substantive, elements that give rise to

---

from the sale of the LIBOR Notes would be inconsistent with recognizing the income from the payments under the Notes"); *id.* at 3390 (arguing that Commissioner "should not be permitted to . . . cause the recognition of . . . income and then disregard the same transactions in order to deny a loss").

deductible interest obligations." According to ACM, br. at 48, its ownership of the BOT LIBOR notes and its 1991 disposition thereof for an actual economic loss gave rise to a separable, economically substantive loss that is properly deductible under *Wexler* because it is distinct from the losses resulting from the ratable basis recovery rule. The Commissioner, on the other hand, contends that *Wexler* does not permit the deduction of ACM's economic losses on the LIBOR notes because, according to the Commissioner's interpretation of *Wexler*, a separable item of loss is not deductible unless the underlying transaction had a potential non-tax benefit. *See* br. at 48-49.

For the following reasons, we find ACM's contentions to be more persuasive. In *Wexler*, the taxpayer invoked *Rice's Toyota*, 752 F.2d at 95-96, which disallowed depreciation and interest deductions arising from a transaction that was a sham in that the taxpayer "subjectively lacked a business purpose and the transaction objectively lacked economic substance." The court found, however, that one discrete portion of the transaction, which entailed the exchange of a recourse note for "something of economic value," had sufficient economic substance to give rise to an interest deduction. *Id.* at 95-96. Distinguishing *Rice's Toyota*, we found that the claimed deductions in *Wexler* did not constitute such a "separable, economically substantive" item that was distinct from the sham aspects of the transaction, but rather constituted "the principal tax benefits of the transaction." *Wexler*, 31 F.3d at 125. Thus, we found, allowance of the deduction would have permitted the taxpayer "to reap the entire benefit of its sham transaction" by allowing him the deduction "that was the centerpiece of the whole scheme." *Id.* at 127.

Such is not the case here. The actual economic losses associated with ACM's ownership of the LIBOR notes are both economically substantive and separable from the sham aspects of the underlying transaction. Far from being the "centerpiece" or "principal tax benefit" of the underlying transaction, the approximately $6 million in economic losses

which ACM seeks to deduct were separate and distinct from the $87 million tax loss that did not correspond to any actual economic loss but rather was an artifact of the ratable basis recovery rule which inflated the tax basis of the LIBOR notes well above their actual cost basis. In contrast to its economically inconsequential acquisition and disposition of the Citicorp notes, ACM's ownership of the BOT LIBOR notes, which extended over two years under circumstances that posed an actual risk to the principal value of that investment, had an economically substantive impact on ACM's net financial position. In these circumstances, recognition of both the income and the loss aspects of ACM's investment in those notes will result in consistent tax treatment which accurately reflects the economic reality of ACM's transactions and will allow deduction only of a "separable, economically substantive" item that is not the "centerpiece" of the transactions, consistently with our holding in *Wexler*.

While the Commissioner, br. at 48, urges us to read *Wexler* more broadly to preclude any deductions associated with an underlying transaction found to be a sham, we decline to do so. We recognize that *Wexler* not only distinguished *Rice's Toyota* on its facts, but also criticized its reasoning. In doing so, however, *Wexler* did not criticize *Rice's Toyota's* essential holding that "in some circumstances, a sham transaction may have separable, economically substantive elements that give rise to deductible" liabilities, *see* 31 F.3d at 127, but rather disagreed with the *Rice's Toyota* court's finding that the recourse note portion of the transaction, which the court had described as "a 'fee' for purchase of expected tax benefits," had economic substance. As we explained in *Wexler*, by the *Rice's Toyota* court's own description, that transaction had no non-tax consequences and served no non-tax purposes and thus could not be considered economically substantive even if it was separable from the central aspects of the underlying sham. *See Wexler*, 31 F.3d at 125 (quoting *Rice's Toyota*, 752 F.2d at 94).

ACM's possession of the LIBOR notes, although not intended to serve non-tax purposes, had significant non-tax economic effects, consisting of several million dollars in actual economic losses. As we acknowledged in *Wexler*, even where a transaction is not intended to serve business purposes, it may give rise to a deduction to the extent that it has objective economic consequences apart from tax benefits. *See* 31 F.3d at 126 (*citing Jacobson*, 915 F.2d at 849); *see* also *Gregory*, 293 U.S. at 469, 55 S.Ct. at 267 (holding that if the transaction "in reality was effected" in substance as well as in form, "the ulterior [tax avoidance] purposes . . . will be disregarded); *Northern Indiana Pub. Serv. Co.*, 115 F.3d at 512 (holding that *Gregory* and its progency "do not allow the Commissioner to disregard economic transactions . . . which result in actual, non-tax-related changes in economic position" regardless of "tax-avoidance motive"). Thus, we are unpersuaded by the Commissioner's assertion that *Wexler* requires us to disregard actual, objective economic losses merely because they are incidental to a broader series of transactions that are found to constitute an economic sham whose principal tax benefits must be denied. *See* br. at 48-49. Because ACM's possession and disposition of the LIBOR notes was distinct from the contingent installment exchange which constituted the underlying sham transaction and because this distinct portion of the transaction had sufficient non-tax economic effect to be recognized as economically substantive, we find that this aspect of ACM's transactions gave rise to the type of "separable, economically substantive" loss that is deductible even when incurred in the context of a broader transaction that constitutes an economic sham. *Wexler*, 31 F.3d at 127. Accordingly, we will reverse the Tax Court's decision to the extent that it disallowed the deductions arising from the actual economic losses which ACM sustained upon its disposition of the LIBOR notes.

IV. CONCLUSION

For the foregoing reasons, we will affirm the Tax Court's application of the economic substance doctrine and its resulting decision eliminating the capital gains and losses attributable to ACM's application of the contingent installment sale provisions and the ratable basis recovery rule. The Commissioner's cross appeal is moot and thus will be dismissed. We will, however, reverse the Tax Court's decision insofar as it disallowed the deductions arising from the actual economic losses associated with ACM's ownership of the LIBOR notes, and will remand to the Tax Court for entry of a decision consistent with this opinion. The parties will bear their own costs on this appeal.

McKEE, *Circuit Judge*, dissenting.

By finding that ACM's sales of the Citicorp notes for cash and LIBOR Notes "satisfied each requirement of the contingent installment sales provisions and the ratable basis recovery rule," Maj. Op. at 28, yet, simultaneously subjecting these transactions to an economic substance and sham transaction analysis, the majority has ignored the plain language of IRC § 1001, and controlling Supreme Court precedent. We have injected the "economic substance" analysis into an inquiry where it does not belong. Therefore, I respectfully dissent.

ACM, like all taxpayers, has the absolute right to decrease or to avoid the payment of taxes so long as that goal is achieved legally. *Gregory v. Helvering*, 293 U.S. 465, 468 (1935). *Id.* In *Gregory*, the taxpayer wanted to transfer stock from her wholly-owned corporation to herself, but realized that a direct distribution of those shares would be a taxable event. Therefore, in an attempt to avoid a taxable event, the taxpayer created a new corporation, transferred the stock to that new corporation, and then caused the new corporation to distribute the stock to her in liquidation. The taxpayer owned

all of the stock of United Mortgage Corporation, and that corporation owned 1000 shares of the Monitor Securities Corporation that the taxpayer wanted to obtain. In order to do so without paying the taxes that would clearly be due on a direct transfer, she engineered a purported reorganization of United Mortgage Corporation. The Supreme Court described her scheme as follows:

> To that end, she caused the Averill Corporation to be organized under the laws of Delaware on September 18, 1928. Three days later, the United Mortgage Corporation transferred to the Averill Corporation the 1,000 shares of Monitor stock, for which all the shares of the Averill Corporation were issued to the petitioner. On September 24, the Averill Corporation was dissolved, and liquidated by distributing all its assets, namely, the Monitor shares, to the petitioner. *No other business was ever transacted, or intended to be transacted, by that company.* The petitioner immediately sold the Monitor shares. . . .

Gregory, 293 U.S. at 467 (emphasis added). At the time, 26 USCA § 112 (g) exempted the gain realized from a corporate reorganization "[i]f there is distributed, in pursuance of a plan of reorganization, to a shareholder, . . . stock . . . in such corporation." *Id.* at 468. Most significantly for our purposes, the Court stated the issue as follows: "[b]ut the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended." *Id.* at 469. The Court concluded that what was done was not what the statute intended because the liquidation was not a plan of reorganization at all, but "a transfer of assets by one corporation to another in pursuance of a plan having no relation to the business of either. . . ." *Id.* Accordingly, the Court disregarded the transaction, even though the form of the transaction satisfied the literal requirements of the IRC's reorganization provisions, because it found that the entire transaction was nothing but "an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else." *Id.* at 470. In other words, the transaction was

one which "upon its face lies outside the plain intent of the statute." *Id.* Consequently, "the rule which excludes from consideration the motive of tax avoidance" did not apply. *Id.*

Accordingly, I am not as persuaded as my colleagues that *Gregory* should guide our inquiry into these transactions. Here, the sales of the Citicorp Notes for cash and LIBOR Notes were clearly "legitimate" sales in the nontax sense. Under IRC § 1001, the tax consequences of a gain or loss in the value of property are deferred until the taxpayer realizes the gain or loss. *Cottage Savings Assoc. v. Commissioner*, 499 U.S. 554, 559 (1991). The concept of "realization" is implicit in IRC § 1001(a), *Id.*, and the realized gain is recognized when the property is sold or exchanged. IRC § 1001(c).[1] In *Cottage Savings*, the Court held that a sale or exchange of property is a realization event "so long as the exchanged properties are 'materially different'—that is, so long as they embody legally distinct entitlements.' *Id.* at 566.

> Cottage Savings sold 90% participation in 252 mortgages to four S&L's. It simultaneously purchased 90% participation interests in 305 mortgages held by these S&L's. All of the loans involved in the transaction were secured by single-family homes. . . .
>
> On its 1980 federal income tax return, Cottage Savings claimed a deduction . . . which represented the adjusted difference between the face value of the participation interests that it traded and the fair market value of the participation interests it received.
>
> . . .

Cottage Savings, 499 U.S. at 557. It was not disputed that "[t]he . . . acknowledged purpose [of the transfers] was to facilitate transactions that would generate tax losses but that

---

[1] IRC § 1001(c) provides: "(c) Recognition of Gain or Loss.—Except as otherwise provided in this subtitle, the entire amount of the gain or loss, determined under this section, on the sale or exchange of property, shall be recognized."

would not substantially affect the economic position of the transacting S&L's". *Id.* at 556. In allowing the taxpayer to deduct the resulting loss the Court reasoned that §1001 did not recognize exchanges "commonly known as 'like kind', and that Congress therefore intended to afford tax recognition of gains and losses resulting from exchanges of property that was materially different." *Id.*, at 564. The Court held "[u]nder our interpretation of §1001(a), an exchange of property gives rise to a realization event so long as the exchanged properties are 'materially different'—that is, so long as they embody legally distinct entitlements." *Id.* That is what happened here, and I believe that, under *Cottage Savings*, the tax loss here should have been allowed.

ACM's sales of the Citicorp Notes for cash and LIBOR Notes resulted in the exchange of materially different property with "legally distinct entitlements.". Consequently, the sales were substantive dispositions, and the tax effects of those transactions should be recognized. *Cottage Savings*, as well as the plain language of IRC §1001, demands that result.

Thus, I do not think that the many cases decided before *Cottage Savings* that the majority relies upon are helpful. *e.g.*, Maj. Op. at 26-34. Similarly, I do not believe our inquiry is furthered by discussing *United States v. Wexler*, 31 F.3d 117 (3rd Cir. 1994). *See Maj. Op.* at 45. There, we were not addressing the issue of sham transactions in the context presented here, nor did we cite Cottage Savings. We did cite *Lerman v. Commis*sioner, 939 F.2d 44, 45 (3d Cir. 1991), and we noted that, in *Lerman*, we said "'economic substance is a prerequisite to any Code provision allowing deductions.' " 31 F.3d at 127 (quoting *Lerman*, 939 F.2d at 48 & n. 6, 52). However, it is the definition of "economic substance" that is the sticking point. Here, the "economic substance" inquiry must be governed by the "material difference requirement" of *Cottage Savings*, not by the tax avoidance intent of the taxpayers.

In this regard, I believe the majority mischaracterizes the appellant's argument. The majority states: "ACM acknowledges that even where the 'form of the taxpayer's

activities indisputably satisfie[s] the literal requirements' of the statutory language, the courts must examine 'whether the substance of those transactions was consistent with their form' ". Maj. Op. at 29 (quoting Appellant's Br. at 21). However, ACM is referring to the issue as posed by *Gregory v. Helvering*. In referring to the facts of that case, ACM argues:

> The form of the taxpayer's activities indisputably satisfied the literal requirements of the Code's reorganization provisions, but the question was whether the substance of those transactions was consistent with their form. As he does here, the Commissioner argued in Gregory that the taxpayer's ulterior purpose should be disregarded. . . .
>
> In other words, the focus should be on the substance of what was done, and not on why it was done. The Supreme Court then analyzed the specific statutory language concerning reorganizations and concluded that the taxpayer's actions lay outside the plain intent of the statute.

Appellant's Br. at 21.

As recited earlier, ACM's sales of the Citicorp Notes for cash and LIBOR Notes resulted in the exchange of materially different property. I believe our inquiry should proceed no further, and reverse the holding of the Tax Court eliminating the capital gains and losses attributable to ACM's application of the contingent installment sale provisions and the ratable basis recovery rule to its disposition of the Citicorp Notes.

I can't help but suspect that the majority's conclusion to the contrary is, in its essence, something akin to a "smell test." If the scheme in question smells bad, the intent to avoid taxes defines the result as we do not want the taxpayer to "put one over." However, the issue clearly is not whether ACM put one over on the Commissioner, or used LIBOR notes to "pull the wool over his eyes." The issue is whether what ACM did qualifies for the tax treatment it seeks under §1001. The fact

that ACM may have "put one over" in crafting these transactions ought not to influence our inquiry. Our inquiry is cerebral, not visceral. To the extent that the Commissioner is offended by these transactions he should address Congress and/or the rulemaking process, and not the courts.[2]

Accordingly I must dissent from what I admit is a very finely crafted opinion by my colleague, Judge Greenberg.

A True Copy:
Teste:

Clerk of the United States Court of Appeals
for the Third Circuit

---

[2] As the majority notes, the Commissioner apparently realized the possible "loophole" in the regulations and enacted Treas. Reg. §1.701-2(a) in an apparent effort to curb such tax driven transactions as the ones here. *See* Maj. Op. at 29-30, n. 29.

APPENDIX B

T.C. Memo. 1997-115

UNITED STATES TAX COURT

ACM PARTNERSHIP, SOUTHAMPTON-HAMILTON COMPANY, TAX MATTERS PARTNER, Petitioner, v. COMMISSIONER OF INTERNAL REVENUE, Respondent.

Docket No. 10472-93. Filed March 5, 1997.

In 1998, C reported a $105 million capital gain. In 1989, M, an investment banking firm, approached C with an elaborate scheme to shelter that gain from Federal income tax. Pursuant to M's advice, A, C, and M created an offshore partnership (P) in which their respective initial interests were 82.63, 17.07, and .29 percent. P served as the vehicle for a contingent installment sale transaction (CINS transaction) that would create approximately $100 million of capital losses for C, a domestic corporation, and corresponding capital gains for A, a foreign corporation that was not subject to U.S. tax. Pursuant to the scheme, P purchased

securities and, approximately 3 weeks later, sold most of the securities for cash and LIBOR Notes. The value of the total consideration received, in the form of cash and LIBOR Notes, equaled the price that P had paid for the securities sold. The transactions and the returns connected thereto were the result of a carefully crafted and faithfully executed sequence of sophisticated and costly financial maneuvers that left little to chance or market opportunities. P used the contingent payment sale provisions of sec. 15a. 453-1(c), Temporary Income Tax Regs., 46 Fed. Reg. 10711 (Feb. 4, 1981), to report the sale for Federal income tax purposes. In accordance therewith, P reported a large capital gain in the year of sale; most of this gain was allocated to A. In a later year, after P redeemed A's entire interest, P sold the notes and reported a corresponding capital loss, most of which was allocated to C. The loss was carried back to 1988 by C to offset its gain. Held: The Court will disregard the CINS transaction for federal income tax purposes because it lacked economic substance.

Fred T. Goldberg Jr., Albert H. Turkus, Pamela F. Olson, William L. Goldman, Christopher Kliefoth, and Joni Lupovitz, for petitioner.

Jill A. Frisch, Patricia A. Donahue, Edward D. Fickess, Sheila Olaksen, Elizabeth P. Flores, Brian J. Condon, and James M. Guiry, for respondent.

CONTENTS

Findings of Fact

1. The Contingent Installment Sale Transaction 5
2. Development of Colgate's Liability Management Partnership 9
3. The Partners 23

4. The Partnership Agreement 27
5. Initial Stage of Colgate's Partnership Strategy 33
6. Tax and Financial Accounting for the Results 45
7. Final Stage of Colgate's Partnership Strategy 51
8. Merrill's Collateral Swap Transactions 56
9. ABN's Investment Management 66

Opinion

1. Mechanics of a Contingent Payment Sale 78

2. Economic Substance 80

a. Introduction 80

b. Profit 91

c. Hedging Within the Four Corners of the Partnership 105
d. Interim Use for Idle Cash 123
e. The Pattern of Ostensibly Market-Driven Decisions 127

MEMORANDUM FINDINGS OF FACT AND OPINION

LARO, Judge: ACM Partnership (ACM or the partnership), Southampton-Hamilton Co. (Southampton), Tax Matters Partner, petitioned the Court under section 6226 to readjust respondent's adjustments of partnership items flowing from the partnership. Respondent issued ACM a notice of final partnership administrative adjustment (FPAA) that reflects adjustments to ACM's partnership return of

income for its taxable years ended November 30, 1989 (FYE 11/30/89), November 30, 1990 (FYE 11/30/90), November 30, 1991 (FYE 11/30/91), and December 31, 1991 (FYE 12/31/91). In relevant part, respondent eliminated the capital gain reported by ACM in FYE 11/30/89 as resulting from the transaction described herein, and she disallowed the corresponding capital loss reported in FYE 12/31/91.

Respondent asserted a number of alternative theories in the FPAA to support the adjustments. Primarily, respondent asserted, the purchase and sale of the debt instruments at issue herein were prearranged and predetermined, devoid of economic substance, and lacking in economic reality. Alternatively, respondent asserted, ACM's activities must be disregarded under the step transaction doctrine, ACM's activities were not engaged in for profit within the meaning of section 183, and the sale of the subject debt instruments did not satisfy the formal requirements for a contingent payment sale under section 15a.453-1(c)(1), Temporary Income Tax Regs., 46 Fed. Reg. 10711 (Feb. 4, 1981).

Following respondent's concession of a number of these alternative theories, the parties ask the Court to decide the following issues:

(1) Whether respondent's adjustments to items of income and loss reported by ACM on the subject transactions should be sustained on the ground that the transactions lacked economic substance. We hold they should.

(2) Whether, as alleged by respondent in her amendment to answer, the foreign partner should be treated as a lender for Federal income tax purposes. In view of our disposition of the first issue, we do not decide this issue. Consistent with the FPAA, as well as the manner in which ACM reported the foreign partner on its returns, we assume that the foreign partner is not a lender.

(3) Whether ACM's allocation of taxable gain on the sale had substantial economic effect or was otherwise in accordance with the partners' interests in the partnership. In

view of our disposition of the first issue, we need not and do not decide the validity of this allocation.

Unless otherwise indicated, section references are to the Internal Revenue Code in effect for the years at issue, and Rule references are to the Tax Court Rules of Practice and Procedure. Throughout this Opinion, we use the terms "purchase", "sale", "contingent installment sale", and "contingent payment sale" solely for purposes of convenience and clarity. Our use of these terms is not meant to give legal significance to the underlying and surrounding transactions.

FINDINGS OF FACT

Some of the facts have been stipulated. The stipulations of fact and attached exhibits are incorporated herein by this reference. When the petition was filed, ACM's principal place of business was in Wilmington, Delaware.

1. The Contingent Installment Sale Transaction

ACM is one of 11 partnerships (section 453 partnerships) formed over a 1-year period from 1989 to 1990 by the Swap Group at Merrill Lynch & Co., Inc.[1] Each section 453 partnership was intended to be a vehicle for sheltering capital gains of one of its partners. For purposes of this Opinion, the principal transactions in which ACM engaged are collectively referred to as the contingent installment sale transaction (CINS transaction).

The design of the CINS transaction appears to have originated in discussions in early 1989 between Macauley Taylor (Taylor), a managing director of Merrill's Swap Group, and James Fields (Fields), a member of his staff. From the spring of 1989 through the summer of 1990, the Swap

---

[1] During the period at issue, Merrill Lynch & Co., Inc., was a holding company that, through subsidiaries and affiliates, provided various financial services. We use the name "Merrill" to refer generally to the affiliated group or a member thereof.

Group and Merrill's investment bankers promoted the idea among Merrill's clients.

Colgate-Palmolive Co. (Colgate) was one of Merrill's clients that Taylor and his staff approached. Colgate's treasury department regularly consulted Henry Yordan (Yordan), a managing director in Merrill's Capital Markets Group, concerning developments in the debt markets. Yordan was aware that Colgate had reported a sizeable capital gain (approximately $105 million) for its 1988 taxable year on its sale of the Kendall Co. (Kendall), and that Colgate might be receptive to the CINS transaction. Through Yordan's introduction, a meeting was held on May 15, 1989, at which Taylor and his staff described the CINS transaction to Colgate's assistant treasurer, Hans Pohlschroeder (Pohlschroeder). Merrill's representatives stated that, apart from the few elements that were essential to secure the desired tax consequences, the partnership structure could be adapted to suit a variety of investment objectives.

Colgate's initial reaction to the proposal was skeptical. Pohlschroeder explained that Colgate did not have the required cash to invest in the partnership, and that the cost of borrowing to finance the investment was likely to exceed the return on a pretax basis. Pohlschroeder also was not persuaded that the partnership would serve a business purpose of Colgate. When Pohlschroeder related the proposal to Steve Belasco (Belasco), Colgate's vice president of taxation, the latter agreed: But for the tax benefits, the transaction did not accomplish anything useful for the company. Belasco also was concerned that the transaction did not have sufficient economic substance to withstand scrutiny, and that the transaction's legal, financial, and accounting complexities would require broad interdepartmental support within Colgate. Absent a connection to Colgate's business, Belasco believed, the necessary support would not be forthcoming.

Merrill's proposal was not the first that Colgate considered to minimize the tax impact of the Kendall sale. During the previous summer, while the sale was pending, a

cross-functional team from Colgate's treasury, accounting, and tax departments had considered at least 11 tax-saving proposals, including investing in low-income housing or property eligible for rehabilitation credits and creating a charitable foundation. All of these proposals were rejected.

After the initial meeting between Colgate and Merrill, Fields, on behalf of Merrill, contacted a law firm for advice on the tax consequences of a CINS transaction. In relevant part, the firm summarized the contemplated transaction as follows: A (a foreign entity), B, and C form the ABC Partnership (ABC) on June 30, 1989, with respective cash contributions of $75, $24, and $1. Immediately thereafter, ABC invests $100 in short-term securities which it sells on December 30, 1989, to an unrelated party. The fair market value and face amount of the short-term securities at the time of the sale is still $100. In consideration for the sale, ABC receives $70 cash and an installment note that provides for six semiannual payments, commencing 6 months after the sale. Each payment equals the sum of a notional principal amount multiplied by the London Interbank Offering Rate (LIBOR) at the start of the semiannual period[2]. ABC uses the $70 cash and the first payment on the installment note to liquidate A's interest in ABC and uses the subsequent interest payments to purchase long-term securities.

Relying on section 15a.453-1(c), Temporary Income Tax Regs., 46 Fed. Reg. 10711 (Feb. 4, 1981), the law firm advised Fields that ABC would be entitled to report the sale of the short-term securities on the installment method, and that ABC would recover an equal portion of its basis in the short-term securities in each year in which a payment on the note could be received. The law firm advised Fields that ABC would recover $25 of its basis in each of the 4 taxable years from 1989 through 1992, and that ABC would have to recognize gain in each of these years to the extent that the

---

[2] LIBOR is the primary fixed income reference rate used in Euro markets.

year's payments exceeded $25. To the extent that the year's payments were less than $25, the law firm advised, ABC would not be allowed to recognize a loss in that year, but ABC would have to carry over that "loss" to a later year in which it would otherwise recognize enough gain on the sale to absorb all or part of the "loss". The law firm advised that any unrecognized loss on the sale would be recognized in the final year of payment.

In a series of telephone calls in early July 1989, Pohlschroeder revisited Merrill's proposal with Yordan, Taylor, and Fields. Pohlschroeder communicated a number of concerns that Colgate had regarding the management of its debt. Pohlschroeder wondered whether there was a way to combine Colgate's financial objectives with Merrill's proposal. On July 18, 1989, Taylor called Pohlschroeder back with a suggestion for resolving the problem. The gist of the conversation can be reconstructed from Pohlschroeder's handwritten notes:

> Mac
>
> > Invest. partnership
> >
> > Based on bus. purpose
> >
> > Economic profit
> >
> > Is this partnership profitable?
> >
> > Every single step to be substantiated
>
> Invest in your own debt
>
> Consolidation of effective control but not majority ownership

2. Development of Colgate's Liability Management Partnership

The notion that Colgate could use a partnership to acquire its own debt was the breakthrough that overcame Colgate's reservations, for it provided the opportunity to design an elaborate superstructure of liability management

functions around Merrill's original tax shelter transaction. To understand the extent to which ACM was designed to serve these functions, we first review the concerns of Colgate's treasury department in this period.

A number of developments during 1988 and 1989 posed special challenges for the management of Colgate's debt. In this period, Colgate radically altered the maturity profile of its debt through two actions. First, it used the proceeds from the sale of Kendall in October 1988 to retire over half a billion dollars of commercial paper constituting all of its U.S. short-term debt. Second, it established an employee stock ownership plan (ESOP) in June 1989, financed by issuing $410 million in long-term debt.

The substitution of long-term debt for short-term debt caused Colgate's average debt maturity to exceed substantially the norm in its industry and increased its exposure to interest rate risk.[3] Colgate's treasury department expected the Federal Reserve to ease monetary policy, causing interest rates to fall in late 1989 or the first half of 1990. In a falling interest rate environment, Colgate would earn a lower return on its cash balances and short-term investments; yet, unlike its competitors with relatively greater amounts of short-term debt, it would be unable to cut its interest expense by refinancing. The establishment of the ESOP had the further consequence of prompting Moody's to downgrade Colgate's long-term debt from A1 to A2 on the ground that the addition of so much long-term debt reduced the company's financial flexibility. In the summer of 1989, Colgate's treasury department was exploring ways to rebalance the term structure of its debt and lower its exposure to falling interest rates. Pohlschroeder raised these issues in his discussions with Merrill's representatives in July 1989.

---

[3] All other things being equal, the longer the maturity of a debt instrument the more sensitive its value will be to fluctuations in market interest rates. Hence, long-term debt tends to carry greater risk than short-term debt of the same issuer.

The discussions also concerned the credit spread at which Colgate's long-term debt was trading. The market's perception of the credit worthiness of a corporation is reflected in the extent to which the yield on the corporation's bonds exceeds the yield on U.S. Treasury instruments of comparable maturity. The "spread to Treasury" of Colgate's long-term debt had exceeded the average for high and medium grade industrials throughout 1988 and, after narrowing in the early part of 1989, had widened markedly during the summer. One reason for this change was the downgrade in Colgate's credit rating in June. Colgate's treasury believed that another factor was widespread speculation that Colgate could become the target of a hostile takeover or leveraged buyout. This led to the emergence of an "event risk" premium that caused Colgate debt to trade at a discount relative to the price that would otherwise obtain. In Colgate's opinion, the market was overestimating the risks of holding Colgate's debt. Thus, Colgate's debt was undervalued, and an opportunity existed to capture subsequent improvements in its perceived credit quality by repurchasing the debt. Yet, Colgate's flexibility to respond to this arbitrage opportunity was constrained by the prospect that a significant reduction in its balance sheet liabilities would enhance its appeal to a potential acquirer.

Through the collaboration of Merrill's Swap Group and Colgate's treasury department, from late July to early October 1989, the partnership gradually took shape. Merrill's first written exposition of the concept, entitled "Colgate Partnership Transaction Summary", dated July 28, 1989, states: "the primary mission of the Partnership is the acquisition and control of Colgate debt". "Colgate Sub.", "A Corp.", and "B Corp." would contribute $30 million, $169.3 million, and $0.7 million, respectively. Colgate Sub. would act as managing general partner with the authority to determine partnership investments. Over a period of several months, the partnership capital would be used to acquire long-term Colgate debt from investors. The partnership would then exchange some of the long-term debt for newly issued

Colgate medium-term debt. Merrill noted that the accounting treatment of the partnership was unclear. Despite Colgate's minority interest, Merrill believed, the partnership might have to be consolidated on Colgate's financial statements if Colgate were deemed to control the partnership. Merrill thought that either result might be advantageous.

By the beginning of October 1989, the design had been revised in two important respects. First, it had been determined that the partnership would be most useful if its transactions were initially kept off of Colgate's balance sheet and its consolidation with Colgate for financial accounting purposes was deferred until such time as Colgate acquired a majority interest in the partnership from the foreign partner. This would enable Colgate to conceal its activities from the market as well as choose more advantageous market conditions for retiring and reissuing the debt. Second, Merrill had devised a mechanism by which Colgate and the foreign partner could share the credit risk with respect to partnership holdings of Colgate debt in different proportions from the so-called treasury (i.e., interest rate) risk. The efficiency of "allocating to each partner the risks that it could bear" would make it possible for Colgate to receive greater benefits from the partnership at less cost. Thus, it was expected that Colgate could negotiate for the right to appropriate all the benefit of the improvement in its credit quality that it expected to occur over time, while negotiating for an option to vary the partners' relative shares of the treasury risk inherent in the debt so as to capitalize on expected changes in interest rates.

A document entitled "Liability Management Partnership Executive Summary", dated October 11, 1989, purports to identify the main non-tax advantages of the contemplated partnership structure at about the time that it was approved by Colgate's senior management.

> The proposed Liability Management Partnership (the "Partnership") has been developed specifically for Colgate-Palmolive ("Colgate") to enable it to most efficiently manage the term

structure of its liabilities, using predominantly its partners' capital. Normally an issuer's acquisition of its own debt involves three events, the acquisition of the debt, the retirement of the old issue and the issuance of substitute financing. The Partnership provides the opportunity to separate the timing of these events * * * by (i) acquiring Colgate debt in the market today, while it remains available, and (ii) placing such debt in "friendly hands," to be retired, modified or exchanged at an advantageous time in the future.

* * * * * * *

Despite the current opportunity to acquire its debt, Colgate does not wish to immediately retire all of such debt and issue substitute financing. This reluctance is based in part on Colgate's current rate outlook (i.e., anticipation of gradual return to a positively-sloped yield curve) and in part on Colgate's desire not to permanently restructure all of such debt immediately. * * *

* * * * * * *

The Partnership provides Colgate with flexibility to exchange the Colgate debt held by the partnership for newly issued Colgate debt of different maturity. Such exchanges may be effected as often and rapidly as Colgate deems appropriate. If Colgate attempted to refinance existing debt within a short time frame by repurchasing it and issuing new debt, transactions costs would rise dramatically. * * *

* * * * * * *

The Partnership also allows Colgate to effectively retire its debt, while leaving the debt outstanding for accounting purposes, and to take a position on rates by adjusting the relative sharing of Treasury risk by the partners. As Colgate bears a relatively greater share of the Treasury risk (i.e.,

losses in value of the Colgate debt attributable to interest rate increases) with respect to its debt, it has economically retired an increasing percentage of such debt and effectively changed its position with respect to interest rates.

The partnership's fulfillment of the liability management purposes for which it was designed would depend on the identity of Colgate's partners. Merrill undertook to procure them. During the summer of 1989, Taylor approached Hans den Baas (den Baas), the head of the Financial Engineering Group at ABN Bank New York (ABN New York),[4] concerning the possibility of ABN's participation in a partnership with Colgate. Taylor explained that the partnership would be used to acquire Colgate long-term debt for liability management purposes. He also stated that a contingent payment sale was contemplated, and that ABN's participation would be limited to 2-3 years. Den Baas forwarded Taylor's inquiry to Peter de Beer (de Beer), head of the legal department of ABN Trust Co., Curacao N.V. (ABN Trust), who would be responsible for structuring the legal aspects of the participation and negotiating the agreements. ABN Trust was engaged in the business of forming and managing Netherlands Antilles' entities to facilitate financial transactions. De Beer agreed to meet Colgate representatives in Bermuda during the middle of October 1989. He learned of the liability management aspects of the proposed partnership only when actual negotiations with Colgate began.

Based on prior dealings with Merrill, both den Baas and de Beer were already familiar with the CINS transaction and the defined role of the participating foreign partner. Taylor

---

[4] During the period at issue, ABN New York was a subsidiary of Algemene Bank Nederland, N.V., one of the Netherlands' largest financial institutions. ABN Trust Co., Curacao, N.V., was another subsidiary. For purposes of this Opinion, the name "ABN" refers to Algemene Bank Nederland, N.V., or any one of its subsidiaries, affiliates or branches.

had discussed the transaction with den Baas during its development phase early in 1989. Taylor had previously approached den Baas to solicit ABN's participation in a CINS transaction on behalf of at least one other client. In that case too, den Baas had referred him to de Beer, who had represented ABN in the ensuing negotiations.

For a number of reasons, ABN was well suited for the role of majority partner in Colgate's liability management partnership. An ABN affiliate created and managed the foreign partners for each of the 11 section 453 partnerships promoted by Merrill. ABN New York provided financial engineering and other services to the foreign partners in each of the partnerships. Whether or not an understanding that ABN would collaborate as a copromoter existed from the outset, ABN would have had an interest in assuring the satisfaction of Merrill's clients in order to ensure the continuity of a valuable relationship with Merrill. It is unclear whether Colgate was aware of Merrill's relationship with ABN, but Colgate already had an established relationship with ABN. Acting as Colgate's lead bank in the Netherlands, ABN had underwritten a large foreign bond issue and performed other services in connection with Colgate's foreign operations. For these reasons, ABN could be trusted to cooperate in keeping the partnership "friendly", by yielding effective control to Colgate, by protecting the confidentiality of Colgate's debt restructuring activities, and by agreeing to relinquish its partnership interest at such time as Colgate might wish to acquire it. ABN's experience and sophistication in regard to European capital markets would assist the partnership in acquiring Colgate's Eurodollar debentures. As a major international bank, ABN possessed the liquidity needed to finance the venture, and, as a major derivatives dealer, it could accommodate, at little or no cost, Colgate's desire for an option to adjust their relative shares of interest rate exposure.

The third partner was to be an affiliate of Merrill. This provided Colgate with further reassurance. An equity interest

would reinforce Merrill's incentive to continue to provide support and to act in a manner consistent with Colgate's interest when arranging the contemplated partnership transactions. Merrill would receive an advisory fee and transaction-based fees for initiating the partnership's asset transfers.

The ultimate challenge for Merrill in designing the liability management partnership was to find a way to integrate each step of the CINS transaction convincingly so that the transaction, as a whole, would stand up for tax purposes. The Swap Group devoted considerable effort to this task. Although the basic insight was incorporated in the initial "Colgate Partnership Transaction Summary" of July 28, 1989, it was refined in subsequent revisions of this document. The version entitled "XYZ Corporation: Revised Partnership Transaction Summary", dated August 17, 1989, set forth an outline of 10 steps to be taken by the partnership summarized as follows:

> Step 1: The partnership is formed with contributions from XYZ Sub., A Corp. and B Corp. of $30 million, $169.3 million and $0.7 million, respectively.
>
> Step 2: The partnership invests $200 million cash in short-term, floating-rate private placement securities pending acquisition of long-term XYZ debt. The private placement notes will be issued by highly rated issuers and will provide the partnership a return greater than comparably rated commercial paper or bank deposits.
>
> Step 3: The partnership sells the private placement notes for a combination of cash, which will be used to acquire XYZ long-term debt over a period of 6 months, and LIBOR-based notes. "The purpose of the LIBOR notes will be to partly hedge the interest rate sensitivity of the long-term XYZ debt acquired by the Partnership." Depending on the maturity of the XYZ debt acquired, Merrill anticipated a ratio of 70-percent cash ($140 million) to 30-percent LIBOR Notes ($60 million).

Step 4: Some long-term XYZ debt is exchanged for newly issued medium-term XYZ debt.

Step 5: If a substantial amount of long-term debt was exchanged, the partnership would likely reduce its holding of the LIBOR Notes in order to rebalance its hedge. "Such a reduction would be necessary because the Medium- Term Debt, received in exchange for long-term XYZ debt, is less interest rate sensitive than the long-term XYZ debt. LIBOR Notes may either be sold directly or distributed to one or more Partners in a non-liquidating distribution."

Steps 6 and 7: Partnership assets are disposed of in the event that the desired investments cannot be made.

Step 8: A Corp.'s partnership interest is "possibly" redeemed at any time after 1 year following formation.

Step 9: The partnership is consolidated with XYZ for financial accounting purposes. The document advises that

> [i]t would be most reasonable for the Partnership to sell the LIBOR Notes and any other LIBOR-based assets if A Corp. is redeemed. Since the principal asset of the Partnership, other than LIBOR Notes and LIBOR-based assets, is likely to be XYZ debt and XYZ would be a 98% partner, the hedge protection provided by the LIBOR Notes and LIBOR-based assets is no longer necessary.

Step 10: B Corp. is eventually retired after a period of years.

In support of its characterization of the LIBOR Notes as a risk management tool, Merrill performed a series of quantitative analyses of the effect of a given change in the level of interest rates on the value of Colgate debt and LIBOR Notes in the partnership portfolio. These analyses purport to demonstrate that the interest rate sensitivity of the interest-

only LIBOR Notes greatly exceeds that of fixed rate debt instruments of equal maturity and is comparable to that of long-term fixed rate debt. Thus, a 100 to 200 basis point increase or decrease in interest rates would produce roughly equal and offsetting changes in the value of $1 of LIBOR Notes, $2.34 of 9 percent 5-year Colgate debt, and $0.88 of 9-5/8 percent 30-year Colgate debt.

Pohlschroeder was impressed with Merrill's analysis. In an October 3, 1989, memorandum written for the purpose of recommending the "ABN Liability Management Partnership" to his superior, Colgate treasurer Brian Heidtke (Heidtke), Pohlschroeder explained how the composition of the partnership's portfolio would be planned to serve the purpose of "risk management within the partnership". "One aspect of importance is the interest rate exposure on the asset of the partnership which consists of Colgate debt. To minimize the exposure to ABN and Colgate, it is planned to convert a portion of the short- term notes to contingent LIBOR Notes as a hedge of the partnership's fixed rate assets." Although the hedge ratio would be determined through negotiations with ABN, he was confident that the partnership could acquire $140 million of Colgate debt, and that $60 million of LIBOR Notes would provide an appropriate level of protection. The plan was to adjust "the LIBOR note hedge" as needed in order "to achieve the ideal Colgate liability structure." Pohlschroeder envisioned "two possible situations arising in the future" which would call for the disposition of some of the LIBOR Notes. One was the exchange of long-term debt for medium- or short-term debt. "Because a shorter term instrument is less volatile, a smaller notional amount of the LIBOR Note is required for hedging purposes." A second situation was a change in the treasury risk sharing ratios. "The partnership is overhedged when Colgate decides to take more of the treasury risk and ABN reduces its share of the treasury risk. Conversely, as ABN's participation goes up, it needs more of a hedge in [the] form of the LIBOR notes."

Merrill provided Colgate with estimates of the expected costs of the contemplated partnership transactions. The "Perpetual Partnership Cost Component Analysis" reproduced in modified form below was prepared based on market conditions prevailing on September 1, 1989, and evidently assumed that the partnership would remain in existence indefinitely after these transactions were completed.

Perpetual Partnership Cost Component Analysis
($ millions)

	After Tax	Pretax[1]
Net present value before transaction costs & advisory fee	$25.47	---
Cost Components:		
Origination of Citicorp Notes	1.32	$2.00
Remarketing of LIBOR Notes	1.29	1.95
Preferred returns to partners	0.74	1.12
Premium on debt tender	0.48	0.73
Legal expenses	0.17	0.25
Advisory fee	1.32	1.75
Total	5.32	7.80
Net present value of partnership investment	20.15	---

[1]In its review of these costs, as part of a separate document, Colgate translated aftertax amounts into pretax amounts using a 34-percent marginal rate. The original aftertax estimate of Merrill's advisory fee ($1.32 million) would imply a pretax amount of $2 million. The discrepancy between this and the $1.75 million figure reflected in this separate document was not explained.

The "origination" cost refers to the transaction cost that the partnership would incur on the exchange of private placement notes for cash and LIBOR Notes. The remarketing cost represents the transaction cost that would be incurred on the sale of the LIBOR Notes. The preferred return was an estimate of the additional allocation of income that the majority partner was

expected to require. The advisory fee was payable to Merrill for its services. Colgate's management understood that most, if not all, of these costs would be borne by Colgate because all the liability management and tax benefits of the partnership transactions would enure to Colgate. They believed that the costs, though high in absolute terms, were reasonable in relation to the benefits that Colgate expected to receive from the partnership.

Liability management benefits would have been difficult to quantify for purposes of this comparison. The tax benefits, however, were calculable and greatly exceeded the expected transaction costs. Although the Perpetual Partnership Cost Component Analysis does not explain the derivation of the $25.47 million net present value that appears on the top line, this figure must be attributable almost entirely to tax benefits. A succession of summaries, cash-flow projections, and flip-chart presentations that Colgate received from Merrill between August and mid-October 1989, demonstrated how the sale of $200 million private placement notes for $140 million cash and $60 million market value of LIBOR Notes would result in $107 million taxable gain for the partnership and a net taxable loss for Colgate of approximately $90 million. If the foreign partner's interest were acquired and the LIBOR Notes sold within the 2-year period remaining for carryback of capital losses to the year of the Kendall divestiture, the present value of the tax savings achieved by this transaction, discounted at prevailing interest rates of 8-1/2 to 9-1/2 percent, would be roughly $25 million.

In a series of internal meetings and meetings with Merrill representatives during September and early October 1989, the liability management partnership proposal was presented to successively higher levels within Colgate's management. The vice president of taxation was now comfortable with the economic substance of the partnership. The treasurer concluded that this was a "uniquely suitable transaction for us." They, in turn, presented the tax and treasury aspects of the proposal to the chief financial officer and to the president of the company, who approved it. The decision was made to enter into negotiations with ABN.

3. The Partners

ABN chose a form for its participation that would appear on its consolidated balance sheet as a loan to a third party rather than an equity investment. A Netherlands Antilles corporation named Kannex Corp., N.V. (Kannex), would be formed to borrow approximately $170 million from a bank and contribute it to the partnership. Kannex's stock would be held by two Netherlands Antilles stichtingen named Coign and Glamis. Stichtingen are foundations under Dutch law, have no owners, and conduct no commercial activities. Their sole purpose in this transaction would be to hold Kannex's stock. Control over the foundations would be exercised by their respective boards, of which de Beer would serve as chairman and other ABN Trust employees as members. The foundations would appoint ABN Trust to act as sole managing director of the corporation.

Financial arrangements for Kannex's participation were initiated by den Baas at ABN New York. Based on information about the proposed partnership that den Baas had received from Taylor, ABN New York prepared a credit proposal on behalf of Kannex, dated October 3, 1989. Since the borrower's only asset would be an interest in a portfolio expected to consist largely of Colgate long-term debt, ABN New York assessed Colgate's creditworthiness. Under the terms of the proposed credit facility, the bank would loan Kannex $170 million for 1 year at an interest rate of LIBOR plus 30 basis points, corresponding to the rate that the bank would have charged Colgate or a similarly rated company for a line of credit. Colgate was listed as the "client" on the credit proposal. This was because ABN New York viewed the financing transaction as a means of fostering closer banking relations with Colgate. As the credit proposal explained:

> Colgate has been an important prospect for ABN New York Branch because of its strong financial condition and extensive international operations. Establishing a relationship has proven difficult because of the company's loyalty to its line banks.

> ABN's past involvement has been limited to facilities for Colgate subsidiaries. * * * We believe that the proposed transaction would provide an excellent entry into the parent's banking relationship.

Although the interest rate on the loan would provide an acceptable return commensurate with the level of the credit risk involved, ABN New York expected that the total returns to the bank from the loan transaction would be appreciably higher. The bank would also earn sizeable profits off the bid-ask spread on swaps necessary to stabilize Kannex's return from the assets in the partnership portfolio so that it could repay the loan.[5] Because of the size of the loan, approval was required at three levels within the bank: The credit committee at ABN New York, the North American Credit Committee (NACC) in Chicago, and the Risk Management Dept. (RMD) in Amsterdam.

After approval by ABN New York, NACC reviewed the proposal together with a memorandum describing the partnership. On October 11, 1989, sent an advice to RMD recommending approval subject to a number of conditions, of which three are noteworthy:

1) The timing of the purchases and sales of the various securities be adhered to as proposed such that the credit risk is no greater than as outlined in partnership memo.

2) Interest rate risk is fully hedged.

3) Colgate's obligation to purchase Kannex's interest in the partnership by 11/30/89 [sic] is unconditional (will those proceeds be assigned to ABN?)

---

[5] A bid-ask spread is the spread between the price at which an instrument is bought and sold. The bid price is the price at which dealers buy the instrument, and the ask price is the price at which dealers sell the instrument.

RMD advised NACC and ABN New York of its decision: "We agree on the condition that Merrill again verbally states to the partners that they will buy the MTN's at par on November 29, 1989." The reference to "MTN's", or medium-term notes, evidently denotes the private placement notes in which the partnership was expected to invest the partners' contributions pending acquisition of Colgate debt. The earlier oral assurance to which RMD refers may have been one that Merrill made to the first section 453 partnership in which ABN collaborated, the Nieuw Willemstad Partnership. Failing to locate a buyer for the partnership's private placement notes within the time frame required by the partners, Merrill itself became the counterparty, buying the private placement notes and issuing LIBOR Notes. A second condition was that the loan to Kannex be syndicated in order to reduce the credit risk.

ABN records indicate that the credit proposal was "approved per RMD". There is no record of any modification to the NACC and RMD conditions. Under ABN procedures, if credit conditions had been changed, the changes should be reflected in NACC files. Although there are cases in which a branch fails to advise NACC of changes in credit conditions or changes are made without documentation, such cases are rare.

Kannex was incorporated in the Netherlands Antilles on October 25, 1989, and issued shares with a total par value of $6,000, held in equal proportions by Coign and Glamis. Kannex's financial statements reflect accounts receivable for loans to the foundations in the amount of $6,000, indicating that they borrowed from the corporation the funds they used to acquire its stock. By "Revolving Credit Agreement" dated November 2, 1989, ABN's Cayman Islands Branch (ABN Cayman Islands) agreed to make loans available to Kannex in the aggregate amount of $180 million from November 2, 1989, through August 1, 1990. The shares of Kannex stock held by Coign and Glamis were pledged to ABN as security for the loans. Kannex entered into a management agreement

with ABN Trust and a financial services agreement with ABN New York, executed by den Baas, under which ABN New York agreed to provide advice on hedging strategies to reduce Kannex's interest rate exposure and to provide other services at Kannex's request. The agreement does not make provision for either the amount or calculation of ABN New York's compensation.

Southampton, a wholly owned subsidiary of Colgate, was incorporated under Delaware law on October 24, 1989, for the purpose of becoming a partner in Colgate's liability management partnership. Belasco served as Southampton's president and Pohlschroeder as its vice president and treasurer. During the taxable years at issue, Southampton filed a consolidated return with Colgate.

Merrill Lynch MLCS, Inc. (MLCS), was incorporated under Delaware law on October 27, 1989. MLCS is the wholly owned subsidiary of Merrill Lynch Capital Services (Merrill Capital), which operates as the swap dealer for the Merrill Lynch Group. Taylor was MLCS's president and Paul Pepe (Pepe), a member of his staff, its vice president.

4. The Partnership Agreement

Negotiations were conducted at two meetings held in Bermuda on October 18 through 19, and October 27, 1989. The meetings were attended by, inter alia, Heidtke, Pohlschroeder, and Belasco from Colgate; Taylor and Fields from Merrill; de Beer and den Baas from ABN. By agreement dated as of October 27, 1989 (the Partnership Agreement), ACM was formed as a general partnership under New York law with its principal place of business in Curacao, Netherlands Antilles.[6] The partners' initial capital contributions were determined to be as follows:

---

[6] The original name of the partnership was CAM Partnership. At the first meeting of the Partnership Committee, for reasons not disclosed in the record, the initials of Colgate and ABN (A) were reversed, and the name became ACM.

Partner	Capital Contribution	Percentage of Total
Kannex	$169, 400,000	82. 63
Southampton	35,000, 000	17.07
MLCS	600,000	.29
	205, 000, 000	[1]100.00

[1]Includes rounding error of .01

The conduct of the business and affairs of the partnership would be under the direction of a partnership committee (the Partnership Committee) composed of a representative of each of the three partners. In general, action by the Partnership Committee required the assent of partners having an aggregate capital account balance equal to at least 99 percent of the total partners' capital. The affirmative concurrence of both Kannex and Southampton was therefore necessary for most partnership decisions. As its representative, Southampton appointed Pohlschroeder. Kannex appointed de Beer, and MLCS appointed Taylor.

The Partnership Agreement provided that, in general, income, gain, expense, and loss, as reported by the partnership for Federal income tax purposes, would be allocated among the partners in proportion to their respective capital accounts. As subsequent events would demonstrate, this general sharing provision did not fully reflect the partners' original understanding of the manner in which they would share the economic costs of partnership transactions.

Upon the occurrence of specified "Revaluation Events", the partnership would revalue its assets on its books, and any unrealized income, gain, expense, or loss inherent in its assets would be allocated among the partners as if realized in a sale of the assets at their fair market value. These Revaluation Events included: (i) a change in a partner's proportionate interest in partnership capital; (ii) a sale or exchange by the partnership of any Colgate debt instrument; (iii) an adjustment to the Yield Component (as defined below) with respect to Colgate debt; (iv) a contribution or distribution of partnership assets; (v) liquidation of the partnership; (vi) the last business

day of each fiscal year; and (vii) after November 30, 1989, the properly executed request of any partner.

To allocate gains and losses arising in connection with Colgate debt instruments in the partnership portfolio for each revaluation period, the Partnership Agreement distinguished between that portion of any change in value attributable to changes in the general level of interest rates (the Yield Component) and that portion of any change in value attributable to changes in the market's perception of risks specifically associated with Colgate's credit quality (the Quality Component). Together, the Yield Component and Quality Component would capture all of the fluctuation in market value of the Colgate debt held by the partnership.

The Yield Component was initially allocated among the partners based on their respective capital interests.[7] Southampton could elect, however, to change its and Kannex's relative shares of the Yield Component to any level it desired within a specified range, on 5 days notice. It could increase its own share to as much as 49.7 percent, thereby reducing Kannex's share to 51 percent, and it could reduce its own share to as little as 10 percent, causing Kannex to take 89.7 percent.

The allocation of the Quality Component depended on whether Colgate's credit had improved or deteriorated during the relevant revaluation period. Improvement or deterioration was measured by the change in the implied spread of the Colgate debt yield over an index of the yield on U.S. Treasury securities. If Colgate's credit improved, the spread would narrow; if Colgate's credit deteriorated, the spread would widen. The Quality Component was the change in the value of the Colgate debt attributable to this change in the spread. The Partnership Agreement provided for the following Quality Component allocations: (a) For the first 50 basis point

---

[7] Kannex's share was set slightly higher (83 percent) and Southampton's slightly lower (16.7 percent) than their respective capital interests.

decline in value, 84.7 percent of the decline was allocated to Southampton, 15 percent to Kannex, as were subsequent increases within this 50 basis point range; (b) all declines beyond 50 basis points were allocated 99.7 percent to Southampton, and all other increases were allocated 99.7 percent to Southampton. MLCS's share of all changes was 0.3 percent.

The substantial risk shifting potential of the Yield Component option, which was of substantial value to Colgate's liability management scheme, proved relatively unproblematic for ABN because of the bank's ability to hedge interest rate risks outside the partnership through routine techniques employed by financial intermediaries in the derivative markets. Indeed, in its design of this option mechanism, Merrill's Swap Group took for granted ABN's ability to make accommodations in this manner.

The Quality Component provision was a bone of contention for the same reason that the Yield Component provision was not. A credit derivative that could be used by the bank to hedge the share of spread risk allocated to it under this provision was not available in the market at that time. ABN was loath to accept any spread risk for Kannex. On the advice of its tax lawyers, Colgate insisted, and the parties finally agreed, on a sharing formula that limited Kannex's exposure to 7-1/2 basis points (15 percent of a 50 basis point range).

The parties agreed on one further special allocation under the Partnership Agreement. From the date of the initial capital contributions through February 28, 1992, the first $1,241,000 of partnership income and gain for each fiscal year otherwise allocable to Southampton would be allocated to Kannex. This preferred return was not cumulative and was prorated daily. For this purpose, gains otherwise allocable to Southampton did not include unrealized gains resulting from revaluations of partnership assets. ABN had insisted on a preferred return as compensation to Kannex for participating in the spread risk of the Colgate debt. ABN intended that the

amount would also include a small service fee for the adjustments that the bank would have to make to accommodate Southampton's discretionary management of interest rate exposure under the Yield Component provision. As the price for these benefits and as a substitute for the covenants and other legal protections that a lender in the position of Kannex would require as a condition for investing a great deal of money in Colgate debt obligations, Colgate considered the $1.24 million preferred return to be reasonable.

Southampton was required to maintain at least 2 percent of partnership capital. In the event that a substantial widening of the credit spread on Colgate debt caused Southampton's capital account to fall below the 2-percent threshold, unless prevented by insolvency, Southampton would contribute enough additional capital to continue to finance at least a certain minimum amount of the preferred return.

Section 4.03 of the Partnership Agreement governed the maintenance of the partners' capital accounts. The capital accounts would be increased by the amount of the partners' contributions, adjusted for allocations of partnership income, gain, expenses, and loss, and reduced by the fair market value of distributed property. Upon the occurrence of Revaluation Events, the capital accounts would be adjusted to reflect the mark-to-market revaluation of partnership assets.

Each of the partners was entitled to have its interest redeemed at fair market value upon request. Kannex could request redemption at any time after February 28, 1992. The other two partners could request redemption 1 year later. The redemption provision apparently was not the subject of negotiation. It was the intention of the parties that Kannex would be redeemed within 2 years, before its formal right under the Partnership Agreement ripened. The planned duration of Kannex's participation was dictated by the period prescribed for carryback of the capital loss to Colgate's 1988 taxable year. Colgate's plan afforded ABN the convenience of limiting the extent of Kannex's risk exposure.

5. Initial Stage of Colgate's Partnership Strategy

The first meeting of the Partnership Committee (First Partnership Meeting) was held in Bermuda on October 27, 1989. The first noteworthy item of business was to appoint Merrill as qualified appraiser of partnership assets and to authorize both Merrill and ABN to make necessary arrangements for the purchase of three specified issues of Colgate debt: (1) $100 million principal amount of 8.4 percent private placement notes due in 1998 (Met Note) held by the Metropolitan Life Insurance Co. (Met Life); (2) $35 million principal amount of 9.625-percent notes due in 2017 (Long Bonds); (3) $5 million principal amount of 9.5-percent Eurodollar notes due in 1996 (Euro Notes).

Next, the Partnership Committee resolved that "in order to maximize the investment return on its assets pending the acquisition of Colgate-Palmolive Bonds", the partnership authorized Merrill to arrange for the purchase, in the form of a private placement, of $205 million of 5-year floating rate notes with an investor put option exercisable after about 15 to 24 months. Finally, according to the minutes, Pohlschroeder reported that he had communicated an offer to Met Life to purchase the Met Notes at a price within a stated price range, and that Met Life undertook to consider the proposal and review it with tax and legal advisers and, if interested, would come to Bermuda on November 17 in order to complete negotiations. The Partnership Committee authorized ABN Trust to conduct "such further discussions from outside the U.S. as are necessary with Metropolitan prior to such meeting."

During the proceedings in Bermuda, Taylor and Fields, on two separate occasions, presented Pohlschroeder and Belasco with revised estimates of the present value of transaction costs that were likely to be incurred in connection with the anticipated partnership transactions. According to one estimate, the total amounted to $6.95 million before tax, including $1.31 million origination cost on the sale of the private placement securities and issuance of the LIBOR Notes

and $1.0 million for remarketing of the LIBOR Notes. The other estimate was higher: A total of $7.91 million before tax, including origination and remarketing costs of $2.0 million and $1.1 million, respectively. Colgate and Merrill did not discuss the costs of alternative short-term investments for the partnership's cash balances pending acquisition of Colgate debt.

On November 2, 1989, the partners' cash contributions in the amount of $205 million were deposited in the partnership bank account at ABN New York paying interest at a rate of 8.75 percent annually. The funds were withdrawn, at no cost, on the following day. By Private Placement Note Purchase Agreement between ACM and Citicorp, dated November 3, 1989, ACM acquired from Citicorp at par $205 million principal amount of floating rate notes due October 19, 1994 (Citicorp Notes or the Notes). The Citicorp Notes paid interest at the commercial paper rate plus 15 basis points, paid and reset monthly. The initial coupon was set at 8.78 percent and the first reset date was November 15. The Notes were rated AA by Standard & Poors. The holder had the option of tendering the Citicorp Notes for repayment on October 16, 1991, at 100 percent of the principal amount. The Citicorp Notes were not registered under the Securities Act, 15 U.S.C. sec. 77a (1933) and were not traded on an established securities market.

At the time of purchase, it was contemplated that the Citicorp Notes would be sold at the end of the month. Indeed, arrangements to sell the notes were already well underway. In several meetings beginning in late October, Pepe and other Merrill representatives discussed a proposed structure for the sale with the Capital Markets Group of the Bank of Tokyo's (BOT) New York Agency. Parallel discussions were held with the New York Branch of Banque Francaise du Commerce Exterieure (BFCE). During the first week of November, Merrill disclosed the specific terms of its proposal to each bank. The banks would purchase $175 million of the Citicorp Notes, paying 80 percent of the price ($140 million)

in cash and the remainder with an installment purchase note providing for a 5-year LIBOR cash flow having a present value of $35 million. In addition, the banks would enter into collateral swaps with Merrill Capital that provided the banks with risk protection and an attractive return. Merrill had already prepared the legal documentation for the transactions. By facsimile dated November 9, BOT Capital Markets Group sent an urgent request for credit approval to the head office in Tokyo, attaching "all details of the transaction". Merrill required that the agreements be executed within a few days and any delay was likely to result in loss of the deal. On November 10, Merrill informed the banks that, at the asset seller's request, the transaction would be divided between them: BOT would purchase $125 million of the Citicorp Notes and BFCE would purchase $50 million.

If the amount and timing of the partnership's cash needs were so clearly foreseen at the beginning of November, it was in large part because by this time preparations for the acquisition of Colgate debt were also well advanced. The Met Note, Long Bonds, and Euro Notes that the Partnership Committee directed Merrill and ABN to acquire had been targeted for acquisition months earlier. Merrill's first "Partnership Transaction Summary", prepared in July, had contemplated that the partnership would purchase these three issues, using approximately $140 million cash from the sale of the private placement notes. During the summer, Pohlschroeder had told Fields that he knew that Met Life would be willing to sell the Met Note and could probably be induced to sell it immediately. He had arrived at the conclusion as a result of recent unsuccessful attempts by the insurance company to renegotiate the loan agreement. Both the Long Bonds and Euro Notes were identified as good candidates because substantial amounts of these public issues were held by institutions. Based upon his own study of market activities and consultation with traders during the first 6 to 9 months of 1989, Pohlschroeder was able to estimate how much of the Long Bonds and Euro Notes were available. Colgate's treasury department had Yordan perform further

research on availability and price. By the beginning of October, Pohlschroeder felt confident that the partnership would meet Colgate's debt purchase target of approximately $140 million.

The only genuine question in regard to the Met Note was price. In late September, Pohlschroeder contacted Met Life to indicate a possible interest in purchasing the Met Note. On October 23, a few days before he returned to Bermuda to conclude the Partnership Agreement, Pohlschroeder prepared himself for negotiations with Met Life by conferring with Yordan. His notes from that conversation conclude with a reference to the date November 17, which is circled. As the minutes of the First Partnership Meeting reflect, Pohlschroeder contacted Met Life again from Bermuda to invite a representative of the insurance company to negotiate a sale of the note in Bermuda on November 17. The statement in the minutes that Pohlschroeder had communicated an offer on specific terms appears to have no basis in fact, however. It is clear that Pohlschroeder refused to enter into any discussion of terms on that occasion. During the 3 weeks prior to the meeting scheduled for November 16 and 17, Pohlschroeder received a telephone message from Met Life stating the insurance company's asking price. He did not return the call. There were no negotiations prior to the scheduled meeting, either by Colgate within the United States, or by ABN Trust, the partnership's authorized representative for this purpose, outside the United States.

Yordan attended the meeting of the Partnership Committee in Bermuda on October 27 in order to advise the partnership concerning availability and prices of Colgate's Long Bonds and Euro Notes. At this time, Pohlschroeder prepared notes regarding standing orders that ACM intended to issue to Merrill for the purchase of the Long Bonds and Euronotes. The notes apparently reflect a decision as to the timing of these transactions: "Peter de Beer, Curacao will give instructions from C to M.L. after Citi's purchase".

The second partnership meeting was held in Bermuda on November 17, 1989. A representative from Met Life came to Bermuda at this time to negotiate the sale of the Met Note. The negotiation was not lengthy; price was the only issue, and the parties split the difference between their respective offers. By Note Purchase Agreement dated November 17, 1989, and effective December 4, 1989, ACM purchased $100 million principal amount of the Met Note for the aggregate purchase price of $99,291,000 plus accrued interest.

Pohlschroeder reported the successful conclusion of the agreement to the Partnership Committee. According to the minutes, he pointed out that the partnership would now require cash in order to perform its obligations under the Note Purchase Agreement with Met Life. In addition, this investment "would create a risk to the Partnership in the event that interest rates increased because the Met Bonds had a fixed rate of interest." Pohlschroeder recommended "that the Partnership hedge its risk by purchasing notional principal contracts with a floating rate of interest." By resolution of the Partnership Committee, Merrill was authorized to arrange the sale of $175 million principal amount of the Citicorp Notes to one or more of BOT, BFCE, and Mitsubishi Bank "for cash and other LIBOR-based consideration, upon substantially the terms of a draft Installment Purchase Agreement presented to the meeting".

One other significant item of business at the second partnership meeting was the adoption of the "Investment Policy Guidelines" (Investment Guidelines). Weeks before the formation of the Partnership, Pohlschroeder had reported to Heidtke that Colgate would ensure in the Partnership Agreement that the company's own cash management policies would be used as guidance to maintain "liquidity * * * required to facilitate the buyback of long-term debt". As it turned out, the partners were not yet ready to adopt such policies at the time the Partnership Agreement was executed. The primary objective of the belated Investment Guidelines was "to preserve principal". To this end, temporary cash

balances were to be invested in a portfolio of short-term money market instruments selected so as to achieve both a high degree of liquidity and diversification. Upon the liquidation of most of its investment in unregistered 5-year notes of a single issuer, the partnership would be in a position to implement its Investment Guidelines.

On November 27, 1989, ACM sold $175 million principal amount of the Citicorp Notes to BOT ($125 million) and BFCE ($50 million). The aggregate consideration consisted of cash in the amount of $140 million and eight notes requiring quarterly payments of 3-month LIBOR for 20 quarters commencing March 1, 1990, on a notional principal amount of $97.76 million (LIBOR notes).[8] The LIBOR notes were not registered under the Securities Act of 1933 and were not readily tradable on an established securities market. At the time of the transaction, Standard & Poors rated the senior debt of BOT AA and that of BFCE AAA.

The aggregate amount of the consideration paid by the banks included the discount, or origination cost, that Merrill determined it would need to charge for its role in the arrangement and intermediation of the transaction. The discount was 5/8 percent of the par value of the Citicorp Notes, or $1,093,750. The banks issued the LIBOR Notes at a price equal to the aggregate consideration less the cash. The notional principal amount of the Notes was the amount that was required at current market swap rates to give the expected LIBOR cash flows a present value equal to this price.

The following table summarizes the various costs associated with the Citicorp Notes and LIBOR Notes:

---

[8] The term "notional principal amount" means that the principal amount is not actually exchanged; rather, parties agree to exchange payments based on the notional amount.

Citicorp Notes aggregate par amount	$175,000,000
Transaction price	99.375%
Transaction value	173,906,250
Accrued interest (12 days @ 8.65 percent)	504,564
Total consideration	174,410,814

	BOT	BFCE	TOTAL
Citicorp Notes par value	$125,000,000	$50,000,000	$175,000,000
Accrued interest	360,403	144,161	504,564
Cash payment	(100,000,000)	(40,000,000)	(140,000,000)
Cost of LIBOR Notes	25,360,403	10,144,161	35,504,564
Origination cost	(781,250)	(312,500)	(1,093,750)
Issue price/ present value of LIBOR Notes	24,579,153	9,831,661	34,410,814
Notional principal of LIBOR Notes	69,850,000	27,910,000	97,760,000

On the same day that the partnership acquired the LIBOR Notes for the stated purpose of hedging the partners' exposure to interest rate risk associated with the Colgate debt, Southampton served notice of an adjustment to the Yield Component sharing ratio. Desiring greater exposure, Southampton increased its share of the Yield Component from 16.7 percent to 29.7 percent.

ACM invested the $140 million cash received in the sale in several commercial paper issues (time deposits and certificates of deposit (CD's)) maturing December 4, 1989, and bearing interest at 8.15 to 8.20 percent. Upon maturity, these funds became available at no transaction cost to finance the following purchases of Colgate debt between December 4 and 8:

$100 million principal amount of the Met Note for $99,291,000 plus accrued interest;

$1 million principal amount of Euro Notes for $1,025,500 plus accrued interest;

$4 million principal amount of Euro Notes for $4,102,000 plus accrued interest;

$31 million principal amount of Long Bonds for $31,493,396 plus accrued interest.

During November, the groundwork was being laid for the disposition of some of the LIBOR Notes that ACM would acquire in the sale. A memorandum that Merrill prepared for Colgate entitled "Analysis of Partnership Hedging Activity," dated November 13, 1989, purports to demonstrate quantitatively how either an increase in Southampton's share of the interest rate volatility of the Colgate debt from 30 percent to 50 percent or an exchange of the Long Bonds for a new issue of 5-year Colgate debt would warrant a reduction in the amount of the LIBOR Note hedge in the partnership portfolio by approximately $10 million. Merrill reasoned that, in either case, ABN's interest rate exposure would fall by about 30 percent, and a 30-percent reduction in the size of the partnership's hedge would leave the bank's net exposure unchanged. Sometime in November, Pepe approached Neil Schickner (Schickner), head of the Capital Markets Desk at the New York Branch of Sparekassen SDS (Sparekassen).[9] Pepe proposed a transaction involving the purchase of the BFCE LIBOR Notes by Sparekassen and collateral swaps that provided Sparekassen with risk protection and an attractive return. Schickner was already familiar with the transaction structure; at about the same time, Pepe offered him one or two similar deals in connection with other section 453 partnerships. On December 5, in order to conclude the deal,

---

[9] During 1989, Sparekassen was the largest savings bank in Denmark. Later, in the same year, it merged with the two other banks to form Unibank. We refer to the bank at all times as Sparekassen.

Schickner notified the bank's headquarters in Copenhagen that he was reserving a credit line in the amount of $10 million.

The third partnership meeting took place on December 12, 1989, in Curacao. On behalf of Southampton, Pohlschroeder served notice of an adjustment in the Yield Component, whereby Southampton elected to increase its share of interest rate exposure to 39.7 percent. Next, the Committee voted to accede to a Colgate proposal to exchange $4.7 million aggregate principal amount of the Long Bonds plus $4,165 cash payment for $5 million aggregate principal amount of new 3-1/2 year fixed rate debt.

> Macauley Taylor next stated that the debt exchange contemplated by the foregoing resolutions would reduce the Partnership's exposure to the risk of interest rate fluctuations and recommended that the Partnership reduce its position in the variable rate instruments purchased to hedge against such exposure. He reported that a reduction of approximately 30 percent in the hedging provided by the Installment Purchase Agreements executed by the Partnership on November 27, 1989 would be economically advisable. He noted that this reduction would not adversely affect Kannex because of the adjustment of sharing of Yield Component effected by the notice dated December 12, 1989, from Southampton to the Partnership Committee.

It was decided that the BFCE Notes would be distributed to Southampton as a partial return of capital. ACM assigned the BFCE Notes to Southampton as of December 13. By Assignment Agreements dated December 22, 1989, Southampton agreed to assign the notes to Sparekassen for aggregate consideration of $9,406,180. The discrepancy between the issue price at which the Notes had been acquired ($9,831,661) and the price that Southampton received on their sale ($9,406,180) was largely attributable to a bid-ask spread

of $390,000. The bid-ask spread reflected the margins above and below mid-market value that Merrill deemed necessary in order to originate and sell the Notes. Estimating cash flows under the Notes from ask-side swap rates and discounting at a spread below LIBOR in its valuation of the Notes at issuance, Merrill was able to create an attractively priced liability for BFCE. Estimating cash flows under the Notes from bid-side swap rates and discounting at a spread above LIBOR in its valuation of the Notes for purposes of the assignment transaction, Merrill was able to create an attractively priced asset for Sparekassen. The remaining portion of the discrepancy, $35,481, was due to a decline in market interest rates over the 3-week period since the issuance of the LIBOR Notes, which caused them to lose value.

6. Tax and Financial Accounting for the Results

For Federal income tax purposes, ACM treated the sale of the Citicorp Notes as a contingent payment sale, governed by section 15a.453-1(c)(3), Temporary Income Tax Regs., 46 Fed. Reg. 10714 (Feb. 4, 1981). As there was no stated maximum selling price and all payments on the LIBOR Notes would be received over a fixed period of 6 taxable years, ACM recovered its basis in the Citicorp Notes ratably over 6 years. On Form 1065, U.S. Partnership Return of Income, for FYE 11/30/89, the partnership reported capital gain of $110,749,239.[10] The gain was allocated among the partners in proportion to their capital accounts as shown on the November 30, 1989, revaluation worksheet: $91,516,689 to Kannex, $18,908,407 to Southampton, and $324,144 to

---

[10] ACM computed the gain as follows:

Payments received in FYE 11/30/89		$140,000,000
Basis recovered in FYE 11/30/89		
Citicorp Note basis plus accrued interest	175,504,564	
Portion allocable to FYE 11/30/89 (1/6)		(29,250,761)
Capital gain		110,749,239

MLCS. The parties to this proceeding have agreed that the partnership's tax basis in the LIBOR Notes immediately after the sale was $146,253,803, an amount that exceeded the cost of the Notes by the gain recognized on the sale.

Kannex paid neither U.S. nor foreign tax on its 82.63 percent distributive share of the partnership capital gain. On its consolidated Federal income tax return for 1989, Colgate reported a net capital loss attributable to Southampton in the amount of $13,521,432, representing the difference between Southampton's distributive share of the partnership capital gain ($18,908,407) and the capital loss that Southampton recognized on the sale of the BFCE Notes to Sparekassen ($32,429,839).[11]

During the years at issue, Colgate retained Arthur Andersen & Co., as its accountants. In connection with the audit of Colgate's consolidated financial statement for 1989, the audit engagement team and Arthur Andersen's tax team discussed with Colgate's treasury, financial, and tax department personnel how to report the partnership and its activities for financial accounting purposes. Representatives of Merrill were also present. An outline was presented of the planned sequence of steps by which the partnership would borrow to redeem ABN's interest in October 1991 and recognize the remainder of the total $100 million capital loss. The auditors were concerned that

---

[11] Colgate computed the loss as follows:

Cash proceeds	$9,406,180
Imputed interest on contingent payments	(48,693)
Amount realized	9,357,487
Citicorp Note basis plus accrued interest	50,144,161
Basis allocable to LIBOR Notes (5/6)	41,786,801
Section 1274 interest accrued by ACM	525
Adjusted basis allocable to LIBOR Notes	41,787,326
Capital loss	32,429,839

recognition of the large tax loss without a corresponding book loss would leave Colgate with an outside basis considerably lower than the value of the partnership assets.[12] The deferred tax liability associated with this built-in gain would have to be recognized for financial accounting purposes, unless the company could demonstrate an "exit tax strategy". With Merrill's assistance, Colgate explained how the low outside basis and deferred tax liability would be eliminated through a series of contemplated tax-free asset and stock transfers among Colgate affiliates some time after 1992. The auditors were of the opinion that until it became clear that they would be sustainable, for the most part the tax benefits of the transaction should not be recognized for financial accounting purposes. They understood from Colgate's account of the partnership, however, that sizable transaction costs would be incurred in connection with its activities. Colgate explained that only a minor amount of these costs would be shared with the other partners. Colgate would bear approximately $5 million, including all of Merrill's advisory fee of $1.7 million as well as approximately $2 million to originate and remarket the LIBOR Notes. The auditors agreed with Colgate that tax benefits from the partnership could be recognized to the extent of the net-of-tax amount of these transaction costs.

On the issue of consolidation, the auditors endorsed Colgate's position. Consolidation would not be required until ABN's retirement, chiefly because the Colgate debt was not effectively retired to the extent that ABN was sharing changes in its market value. In the meantime, since Colgate was using its position in the partnership essentially as a hedge of its liabilities, and would otherwise have used swaps or other conventional hedging operations to accomplish the same purposes, its investment in ACM should be treated in the same manner for financial accounting purposes as a swap. This would entail the recognition of mark-to-market changes in the value of its equity interest on its financial statements.

---

[12] "Outside basis" refers to a partner's basis in its partnership interest.

The Curacao office of Arthur Andersen served as accountants for ACM. In the course of their review of the results for FYE 11/30/89, the auditors noted two problems with the partnership's financial statements. The first problem was that the $1,093,750 discount on the sale of the Citicorp Notes was not reflected in the income statement. The second problem was that the partnership had included this discount in the book value of the LIBOR Notes, contrary to provisions of the Partnership Agreement that required partnership assets to be restated at fair market value on the last day of the fiscal year. Following consultations with the New York office of Arthur Andersen and with Colgate, in February 1990, the audit engagement manager briefed his colleague on the status of the problem:

> Colgate does not want the cost to sell of US $1,093,750 * * * in the November 30, 1989 income statement of ACM. *The reasons are mainly tax driven, as inclusion might set the IRS on top of the reasons why the partnership was constructed in the first place and thus the planned tax losses may be denied by the IRS.* We, in cooperation with Steve Rossi of our New York office, were requested to think with Colgate in order to keep the cost to sell out of the balance sheet. [Emphasis added.]

One proposal under consideration was as follows:

> Leave the LIBOR notes on the balance sheet as they are and reason that one third of the notes will be distributed to Colgate by 1990 and that the remainder of the notes is eventually for the account of Colgate too. This would require a side letter to the partnership agreement stating that the LIBOR notes are the one exception to the valuation rules which now state valuation at market and would state valuation at market and would then state valuation at market increased by the cost to sell the original Citicorp notes.

The partnership followed this approach. Pursuant to the "Summary of Financial Accounting Policies" (Accounting Policies), adopted 2 weeks later at the fourth partnership meeting, the LIBOR Notes would be:

> carried on the books of the Partnership at cost, and adjusted * * * (I) for amortization of principal on a straight-line basis; and (ii) for movements in interest rates upon the following events: (a) distribution of any * * * [LIBOR] notes; (b) redemption of any Partner; and liquidation of the Partnership.

Thus, the LIBOR Notes were initially booked at a cost that included the $1,093,750 transaction costs incurred on their origination. The cost would be amortized over the life of the investment. This amortization would constitute a charge against income, offset by accrued payments on the Notes. If any of the LIBOR Notes were distributed or a partner was redeemed, the amortized balance would be adjusted for changes in value due to interest rate movements and increased by the previously amortized portion of the origination cost. This convention had the effect of ensuring that the origination cost would be borne solely by the partner(s) that held an interest in the Notes, directly or indirectly, at the time they matured or were sold.

The Accounting Policies do not specify the methodology to be used in revaluing the LIBOR Notes to reflect changes in interest rates. The methodology would differ depending on whether the book value was meant to reflect the minimum price at which the Notes could be purchased in the market (ask value), the maximum price at which they could be sold in the market (bid value), or the midpoint between the two (mid-market value). The understanding among the partners on this issue is revealed by the partnership's actual accounting practice. In pricing the LIBOR Notes at issuance, Merrill used an ask-side valuation methodology. The Notes were originally booked at a value based on this price; the bid value of the Notes at that time, as determined by Merrill, was about $1.3

million lower. Thereafter, book value was consistently adjusted to reflect the current ask price. This convention had the effect of ensuring that the bid-ask spread would be borne solely by the partner(s) that held an interest in the Notes, directly or indirectly, at the time they matured or were sold.

Finally, unlike the policies governing the revaluation of Colgate debt, there is no provision in any agreement for adjusting the book value of the LIBOR Notes to reflect changes in the credit quality of the issuers. As a result, any credit risk would be borne only upon the sale of the Notes to a third party.

As a corollary to the Accounting Policies described above, the partners agreed that in the event that any of the LIBOR Notes were distributed to a partner before maturity, they would be distributed at book value. As a result, the distributee partner's capital accounts and outside basis would be reduced. This reduction would result in the distributee in effect paying the full origination cost and bid-ask spread attributable to the distributed LIBOR Notes. In connection with the distribution of the BFCE Notes to Southampton, as of December 13, the partnership's assets were revalued. The book value of the BFCE Notes was adjusted to $10,133,540. For financial and tax accounting purposes, Southampton's capital account was reduced by this amount, resulting in a decrease in its ownership percentage from 16.89 percent to 12.60 percent.

7. Final Stage of Colgate's Partnership Strategy

ACM made additional purchases of Colgate debt from the marketplace as follows:

Issue Acquired	Date	Principal Amount	Aggregate Purchase Price
Euro Notes	6/1/90	$5,000,000	$5,154,861
Long Bonds	9/6/90	4,000,000	3,864,622
Euro Notes	9/11/90	1,750,000	1,859,132
Long Bonds	9/12/90	6,000,000	5,852,290
Euro Notes	10/23/90	2,000,000	2,159,389

There were also exchanges between ACM and Colgate of the Met Note and approximately one-third of the Long Bonds. In January 1990, ACM exchanged the Met Note for a new Colgate Note with substantially identical terms. This new note was, in turn, exchanged on July 26, 1990, for the purpose of rescheduling certain payments.

ACM made two exchanges of the Long Bonds, which totaled $10 million. On December 13, 1989, ACM exchanged $4.7 million principal amount of Long Bonds for $5 million principal amount of Colgate 8.72-percent notes due June 13, 1993. On March 1, 1991, the partnership exchanged $4.85 million principal amount of Long Bonds for $5 million principal amount of Colgate Notes due in 1994. The exchanges of the Long Bonds had the effect of reducing Colgate's original average debt maturity of 13 years by only 2 months (or 1 percent).

At the end of August 1990, Colgate's treasury concluded that a significant change had occurred in the interest rate environment. Inflationary expectations and the prospect of war in the Persian Gulf were causing a rise in long-term interest rates and a steepening of the yield curve. Under these conditions, the value of Colgate debt held by the partnership would fall. Reversing its policy over the past 10 months of accepting substantially greater interest rate exposure than its pro rata share, Colgate caused Southampton to reduce its share of the Yield Component to 10 percent, effective September 6. Thereafter, Southampton adjusted the Yield Component Sharing ratio on two more occasions, maintaining its exposure between 10 and 20 percent.

Contrary to the expectations of Colgate's management, long-term interest rates declined. By the spring of 1991 Colgate's treasury department identified a constellation of factors favoring consolidation of the partnership and retirement of its Colgate debt holdings in the near future. Not only were general interest rates lower, but the credit spreads on Colgate debt had narrowed appreciably, reflecting stronger prices for the company's stock and diminished takeover risk.

Moreover, efforts to locate Colgate debt available for purchase were no longer successful.

By Partnership Interest Purchase Agreements dated June 25, 1991, Colgate acquired a 38.31-percent interest in ACM from Kannex for $85,897,203, and Southampton acquired a 6.69-percent interest in ACM from Kannex for $15 million. As a result of these transactions, Kannex's ownership percentage declined to 43.04 percent. The shift in ownership was accompanied by a revaluation of partnership assets. Changes in asset values were allocated among the partners' respective capital accounts and the purchase price was determined based upon the balance of Kannex's account. In this process, the book value of the BOT LIBOR Notes was adjusted to reflect their current market value increased by $781,250, the full amount of the origination cost attributable to the notes, and 88 percent of the adjustment was allocated to Kannex's capital account. Although not specifically provided for by the partnership's Accounting Policies, a revaluation of the LIBOR Notes under these circumstances was evidently consistent with the agreement among the partners that Kannex would bear none of the origination cost.

By agreement dated November 27, 1991, ACM redeemed the remainder of Kannex's partnership interest for $100,775,915. The redemption was financed in part with cash and in part with the proceeds of a loan from Citibank secured by the partnership's holdings of Colgate debt. In accordance with the Accounting Policies, partnership assets were revalued and unrealized income, gains, and losses were allocated among the partners. For this purpose, a value of $13,974,304 was assigned to the BOT LIBOR Notes, reflecting their current market value increased by the $781,250 origination cost attributable to them. The liquidating distribution that Kannex received was equal to the resulting balance in its capital account.

At the twelfth partnership meeting, held on December 5, 1991, it was observed that

> as Colgate and a subsidiary, Southampton, owned 99.4% of the Partnership, the principal Partners' net economic exposure to the risk of interest rate fluctuations in the value of the Colgate debt was effectively minimal, and the Partnership need not maintain its position in the instruments purchased to hedge against such exposure.

Moreover, the LIBOR Notes "were a highly volatile investment and * * * without the need to hedge interest rate risk, it was unwise for the Partnership to hold them." "[Short-term interest rates had declined steadily in recent months, thereby reducing the value of the instruments." It was resolved that the partnership would sell the LIBOR Notes. The final substantive comment of the meeting was delivered by Belasco, representing Colgate, who noted that "the Partnership had achieved substantially all of its objectives in connection with the acquisition of Colgate bonds and related debt management."

On December 17, 1991, shortly before the close of Colgate's 1991 taxable year, ACM sold the BOT LIBOR Notes to BFCE for $10,961,581. The notes had fallen considerably in value owing to the decline in market interest rates. Eight and one-half percent at the time the first payment on the notes had been determined, 3-month LIBOR was below 5.7 percent when the last payment was determined. The price at which the BOT LIBOR Notes were sold also reflected a remarketing cost corresponding to the bid-ask spread, equal to $440,000.

The economic loss incurred on the sale of the LIBOR Notes was more than compensated for by the tax loss. On its Form 1065 for FYE 12/31/91, ACM reported a capital loss in the amount of $84,997,111. Colgate claimed $84,537,479 as its own and Southampton's combined distributive shares of this loss on its consolidated corporation tax return for the 1991 taxable year. By amended return, Colgate carried this loss back to 1988. The total net tax loss that Colgate achieved through the CINS transaction exceeded $98 million.

As a result of the consolidation of ACM on Colgate's financial statements for 1991, Colgate's reported outstanding long-term indebtedness declined by $124.1 million,[13] approximately one-half of the overall decline in long-term debt during this year. As of December 31, 1991, the value of Southampton's and Colgate's capital accounts plus the proceeds that had been received from sale of BFCE LIBOR Notes exceeded the costs of their combined investment in the partnership by approximately $5.42 million, representing a pre-tax internal rate of return of 4.7 percent. More than 2 percentage points of this return was attributable to the appreciation of the partnership's Colgate debt caused by further declines in interest rates in the month following Kannex's redemption.

8. Merrill's Collateral Swap Transactions

The origination and remarketing costs of nearly $2 million that Colgate incurred through its partnership strategy represented the costs of a highly complex structure of collateral swaps arranged and executed by Merrill for the purpose of accommodating the investment in and divestment of assets qualifying for contingent payment sale treatment. This section outlines the transactions that Merrill entered into with BOT, BFCE, and Sparekassen between the issuance of the LIBOR Notes in November 1989 and the partnership's sale of the BOT LIBOR Notes in December 1991.

To secure the participation of BOT and BFCE in the contingent payment sale desired by ACM, Merrill's Swap Group offered each of the banks a "structured transaction."[14] The structured transaction consisted of two swaps to be executed in

---

[13] This figure represents the aggregate face amount of Colgate long-term debt held by the partnership ($136.6 million) minus the decline that would have occurred in any case during 1991 owing to a scheduled principal payment ($12.5 million).

[14] In financial terminology, a "structured transaction" is one that combines two or more financial instruments or derivatives. Most structured transactions, like those in this case, include at least one derivative.

conjunction with the contingent payment sale, a basis swap related to the asset that the banks would be purchasing and a hedge swap related to the liability that they would be issuing to finance the purchase. The banks' counterparty in these swaps was Merrill Capital. Both sets of swaps were entered into on November 27, 1989.

Under the basis swaps, BOT and BFCE were obligated to make monthly payments to Merrill Capital at the 1-month commercial paper rate plus 15 basis points on notional amounts of $125 million and $50 million, respectively. These payments were equivalent to the interest that the banks received on the Citicorp Notes. In exchange, Merrill Capital was required to make monthly payments to the banks at a rate of 1-month LIBOR plus 25 basis points on identical notional amounts. After 3 months the spread over LIBOR that Merrill Capital was required to pay increased to 40 basis points and in the case of BOT, to 50 basis points after another month, unless on any payment date Merrill Capital elected to terminate the basis swaps and purchase the Citicorp Notes from the banks at par.

The basis swaps served a risk management function for the banks. The net cash flows resulting from the combination of the Citicorp Notes with the basis swaps were tied to LIBOR, the index in terms of which BOT and BFCE, like international banks generally, conducted most of their business. The step-up provisions were negotiated at the request of the banks and were designed to give Merrill Capital a financial incentive to make arrangements for resale of the notes as quickly as possible. Merrill Capital would forgo the exercise of its call option only in the event of a substantial decline in Citicorp's credit that caused the value of the Citicorp Notes to fall by more than the cost of paying the premium.

Under the hedge swaps, Merrill Capital was obligated to make quarterly payments over 5 years equivalent to the LIBOR Note payments that the banks were required to make to ACM. In return, BOT agreed to pay the sum of $25 million in 20 equal quarterly installments plus interest on the unpaid balance at a rate of LIBOR minus 18.75 basis points. BFCE agreed to

pay the sum of $9,831,661 in 20 equal quarterly installments plus interest on the unpaid balance at a rate of LIBOR minus 25 basis points. In addition, there were two upfront payments: Merrill Capital paid $35,000 to BOT, and BFCE paid $168,339 to Merrill Capital. Like the basis swaps, the hedge swaps served a risk management function for the banks. They were designed to replicate the portfolio effects of partly financing the purchase of the Citicorp Notes with a conventional amortizing loan, whose value would not be affected by changes in LIBOR, rather than with the highly volatile LIBOR Notes.[15]

The structured transactions were designed to be remunerative for the dealer, Merrill Capital. Under the basis and hedge swaps, the present value of the banks' payment obligations exceeded the present value of Merrill Capital's obligations. In this way, the swaps were expected to result in the transfer from the banks to Merrill Capital of the 5/8 discount incurred by ACM on the contingent payment sale. To the extent that the basis swap continued beyond 3 months, Merrill Capital would return some or all of the discount to the banks through the stepped up LIBOR payments.

BOT and BFCE would not have participated in the hedge swaps if they did not also perceive an opportunity to profit. Internal bank documents confirm that those who negotiated the structured transactions with Merrill believed that they offered "very attractive", "extremely favorable" terms. According to calculations performed by petitioner's expert Tanya Beder (Beder),[16] the transactions effectively provided both banks with

---

[15] The banks did not actually pay Merrill Capital the full amount of the interest coupons they received from Citicorp, nor did Merrill Capital pay them the full amounts payable to ACM under the LIBOR notes. On each payment date amounts owed by each counterparty to a swap were offset, and only the net payments were made. The netting of payments is standard practice in the swap market and was provided for in all of the swap agreements discussed hereafter.

[16] Beder is affiliated with the New York consulting firm of Capital Market Risk Advisors, and serves on the faculty of the Yale School of Management.

funding at a cost 39 basis points lower than that available in the direct interbank market. The 39 basis points in savings represents each bank's net present value gain from the structured transaction expressed in relation to the amount of the financing involved. Beder's valuation analysis is useful for identifying how the banks expected to gain overall while losing money on both the basis and hedge swaps.

Valuation of the Positions of
BOT and BFCE as of 11/27/89
($ millions = mm)

	BOT	BFCE
LIBOR Notes		
Price rec'd from ACM	$24.58 mm	$9.83 mm
Mid-market value	(24.05) mm	(9.61) mm
Citicorp Notes		
Price paid to ACM	(124.58) mm	(49.83) mm
PV of expected sale proceeds rec'd by banks	125.39 mm	50.15 mm
Hedge Swap		
Liability leg	(24.88) mm	(9.77) mm
Asset leg	24.08 mm	9.62 mm
Basis Swap		
Asset leg	18.77 mm	7.43 mm
Liability leg	(18.22) mm	(7.29) mm
Merrill's cancellation option	(0.89) mm	(0.29) mm
Up-front payment	0.04 mm	(0.17) mm
Net Present Value	222,586	88,323
Implied Funding Spread Under LIBOR	[1]0.39%	[1]0.39%

[1] The approximate calculations are: $222,586 savings divided by $25 million in principal, spread over 2.3 year duration of principal payments; $88,323 savings divided by $9,831,661 in principal, spread over 2.3 year duration of principal payments.

This analysis indicates that the source of the banks' expected gains was Merrill's pricing of the Citicorp Notes and LIBOR

Notes for purposes of the contingent payment sale. These prices reflect sizeable bid-side and ask-side spreads. Transaction spreads generally tend to be wider for structured transactions than for direct market transactions because structured transactions are customized to meet the needs of the end users and often incorporate a premium to the dealer for innovations that competitors are unable to replicate. The spreads implied in Merrill's pricing of the Citicorp Notes and LIBOR Notes represented the costs of the financial engineering that the contingent payment sale required. Accordingly, the costs were charged to ACM. The banks acquired the Citicorp Notes at the bid price and issued the LIBOR Notes at the ask price. The spreads on these two instruments could have been expected, at the time of the contingent payment sale, to result in the transfer of a total of about $1.8 to $1.9 million in value from ACM to the banks. The banks could have expected to retain approximately $300,000 of this value. See diagram 1 *infra* p.63.[17]

It was the understanding of BFCE that Merrill would arrange for the resale of the Citicorp Notes after only 1 month, well in advance of the date that the step-up in Merrill's payments took effect. The written agreement contained no such provision, but Merrill found a buyer, and BFCE sold its $50 million principal amount of Citicorp Notes on December 22, 1989. At the same time, the basis swap between Merrill Capital and BFCE was canceled. In January 1990, the basis swap with BOT was terminated, and the remaining $125 million principal amount of Citicorp Notes was resold.

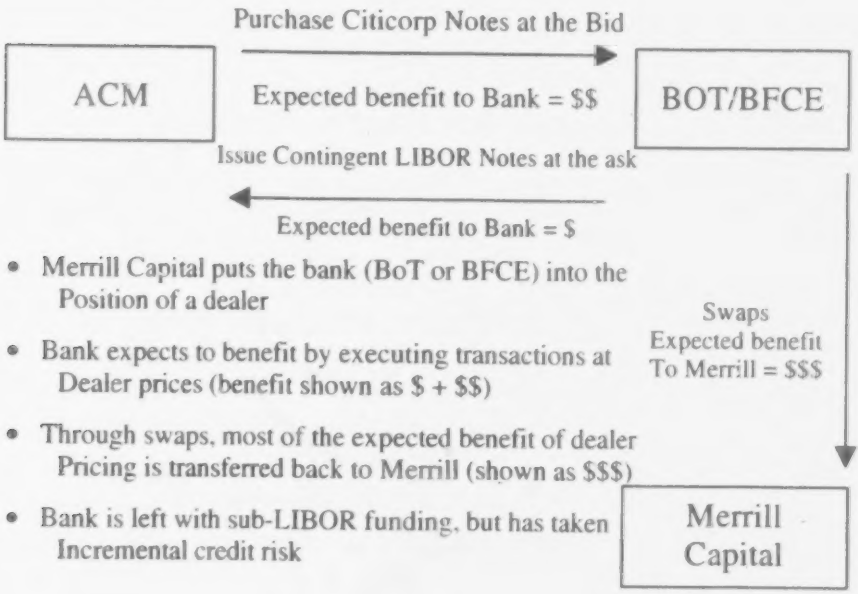
Merrill arranged another structured transaction to facilitate Southampton's sale of the BFCE LIBOR Notes to Sparekassen on December 22, 1989. Under the hedge swap between Merrill Capital and Sparekassen, Sparekassen was obligated to make quarterly payments equivalent to those it was entitled to receive

---

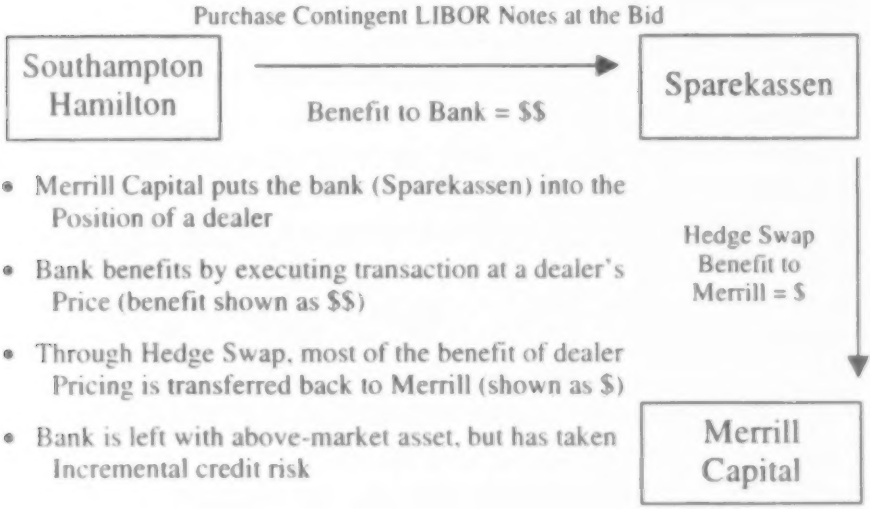
[17] As will be seen hereafter, Merrill Capital did not retain all of the remaining $1.5 to $1.6 million of value extracted from the partnership. Some of this value was transferred back to ABNs and Kannex through a separate set of swaps relating to the LIBOR notes.

from BFCE under the LIBOR Notes. In return, Merrill Capital was required to pay $9,406,180, an amount that corresponded to the purchase price of the notes, in 20 equal quarterly installments, together with interest on the unpaid balance at a rate of LIBOR plus 35 basis points. The spread over LIBOR increased to 85 basis points after March 1, 1990, if Merrill did not first exercise its right to call the notes at a price equal to the unpaid principal balance and terminate the swap. From Sparekassen's perspective, the structured transaction was similar to investing in an amortizing loan that paid a margin over LIBOR, rather than in volatile LIBOR Notes. From Merrill Capital's perspective, the transaction provided an asset whose volatility matched and offset the volatility of its liability under the hedge swap with BFCE or BOT. The step-up in Merrill Capital's payment obligations provided it a financial incentive to exercise its call right and cancel the swap. Petitioner's expert, Beder, concluded that as of the time of its acquisition of the BFCE Notes, Sparekassen could have expected a net present value benefit of $7,208, equivalent to a return on its investment of 41 basis points more than that available in the direct interbank market.

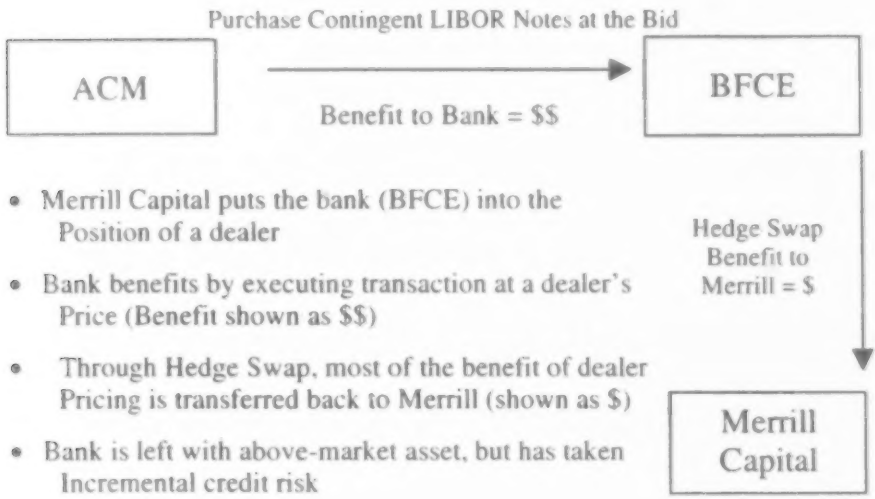
Flow of Benefits in 11/17/89 Structured Transaction
Diagram 1



Flow of Benefits in 12/22/89 Structured Transaction
Diagram 2



Flow of Benefits in 12/17/91 Structured Transaction
Diagram 3



Valuation of Sparekassen's
Position on 12/22/89
($ millions = mm)

LIBOR Notes	
Price paid to Southampton	(9.41) mm
Mid-market value	9.63 mm
Hedge Swap	
Asset leg	9.58 mm
Liability leg	(9.63) mm
Merrill's cancellation option	(0.17) mm
Net Present Value	7,208
Implied Return Over LIBOR	[1]0.41%

[1] The approximate calculation is: $7,208 gain divided by $9,406,180 invested, spread over 0.189 year duration of payments. The calculation assumes that Merrill Capital will cancel the swap on March 1, 1990, when the opportunity to do so first arises: At the inception of the swap, the prospect of a decline in BFCE's credit sufficient to warrant retention of the option at the large cost that this would impose was highly unlikely.

As in the structured transaction that Merrill designed for the other two banks, Sparekassen could expect to lose money on the swap; the source of its gain is the bid-side spread implied in Merrill's pricing of the LIBOR Notes. The transaction pricing resulted in the transfer from Southampton to the bank of more than $200,000 in value, most of which would ultimately enure to the benefit of Merrill Capital. See diagram 2 *supra* p.63.

By agreements among BFCE, Sparekassen and Merrill Capital, the BFCE LIBOR Notes and the two hedge swaps related to them were terminated during 1990.

Merrill arranged another hedge swap for BFCE in conjunction with the bank's purchase of the BOT LIBOR Notes from ACM for $10,961,581 on December 17, 1991. The structure and function of this swap were for the most part identical with those of the hedge swap between Merrill Capital and Sparekassen. BFCE agreed to pay Merrill Capital amounts equal to the flows it was entitled to receive under the

BOT Notes. Merrill Capital agreed to make 12 equal quarterly payments aggregating $10,961,581, together with interest on the unpaid balance at LIBOR plus 35 basis points. The interest rate was stepped up after the first year unless Merrill elected to terminate the swap and acquire the notes at a price equal to the unpaid principal balance remaining on the amortizing leg. For BFCE, the hedge swap effectively created a synthetic asset paying an attractive margin over LIBOR, and, for Merrill Capital, a hedge for its payment obligations under the outstanding swap with BOT.

According to Beder's calculations, the midmarket value of the BOT LIBOR Notes at the time of their sale to BFCE was $11.18 million. The bid-side spread of $220,000 implicit in the purchase price that BFCE paid ACM for the notes financed the gains shared by Merrill and the bank from the transaction. See diagram 3 *supra* p.63. Ultimately, the cost of engineering this structured transaction, like the two before it, was borne almost entirely by Colgate.

9. ABN's Investment Management

In conformity with the requirements for approval of Kannex's loan, den Baas and his colleagues at ABN New York took steps to protect the bank from the risks of Kannex's participation in ACM and to ensure the bank an adequate return. ABN New York had the authority to implement a comprehensive financial management program for Kannex by virtue of ABN New York's financial services agreement. First, Kannex's exposure to the intrinsic interest rate risk of partnership assets would be "fully hedged". Den Baas never considered relying on the partnership's LIBOR Notes for this purpose. He made no attempt to evaluate their hedging effect within the partnership portfolio. It was clear to him that effect would not be adequate, and hedging instruments of greater precision and reliability were available. Accordingly, ABN New York arranged to neutralize the effect of the LIBOR Notes on Kannex's interest. The structure that it employed for this purpose consisted of back-to-back swap transactions with Kannex on the one hand and Merrill

Capital on the other. ABN New York assumed the role of intermediary on the assumption that neither Merrill Capital nor any other third party would accept Kannex's credit risk.

By swap confirmations effective November 27, 1989, the issue date of the LIBOR Notes, ABN New York entered into a hedge swap agreement with Merrill Capital. Under the swap, ABN New York was required to make to Merrill Capital quarterly payments of 3-month LIBOR over 5 years equivalent to Kannex's 82.63 percent pro rata share of the payments owed to ACM under the LIBOR Notes. Merrill Capital was required to pay to ABN New York the sum of $28,433,655 in 20 equal quarterly installments together with interest on the unpaid balance at a rate of LIBOR minus 25 basis points. This amortizing principal amount was equal to 82.63 percent of $34,410,814, Kannex's pro rata share of the issue price of the LIBOR Notes. ABN New York entered into a matching hedge swap with Kannex under which Kannex's rights and obligations vis-a-vis ABN New York corresponded to those of ABN New York vis-a-vis Merrill Capital. When Kannex's indirect interest in the LIBOR Notes held by the partnership changed significantly as a result of the distribution of the BFCE Notes to Southampton on December 13, 1989, the partial purchase of Kannex's partnership interest on June 27, 1991, and the redemption of its remaining interest on November 27, 1991, both legs of the hedge swaps were adjusted proportionately. At these times, the portion of the swap that was to be terminated would be marked to market, and the counterparty that would otherwise have benefitted from the change in market interest rates would receive a compensatory termination payment. The back-to-back hedge swaps satisfied complementary needs. Kannex was able to stabilize its return on $28 million of its partnership investment. Likewise, Merrill Capital was able partly to offset the interest rate exposure that it incurred in connection with its hedge swaps with BOT and BFCE.

The back-to-back hedge swaps relating to the LIBOR Notes also served an additional function that can be

understood only by reference to the terms of the structured transactions in which the LIBOR Notes were issued. According to the analysis of petitioner's expert, the transaction spreads implied in Merrill's pricing of the Citicorp Notes and LIBOR Notes for purposes of the contingent payment sale could be expected to result in the transfer of between $1.8 and $1.9 million of value from ACM to the foreign banks. The banks could have expected to retain only about $300,000 of this value, because their basis and hedge swaps with Merrill Capital were structured in such a way that the present value of the swap payments they were entitled to receive from Merrill Capital was less than the present value of the swap payments they were obligated to pay to Merrill Capital. Thus, the value of BFCE's right to quarterly payments of 3-month LIBOR Notes over 5 years on a notional principal amount of $27.91 million was $9.62 million, while the value of its obligation to pay $9,831,661 in equal quarterly installments over 5 years together with interest on the unpaid balance at LIBOR minus 25 basis points was $9.77 million. As a result of the discrepancy in the value of these two legs of the hedge swap, Merrill Capital could have expected to realize a net gain, and BFCE a net loss, of $150,000.

The hedge swap between Merrill Capital and ABN was structured in a manner similar to the hedge swap between BFCE and Merrill Capital. The ABN swap differed from the BFCE swap in only two respects. First, the payment obligations on both sides of the ABN swap were proportionately larger. In the BFCE swap, the notional principal amount of the fixed notional leg was set at an amount ($27.91 million) equal to 50/175, or 28.5 percent, of the combined total notional principal amount of the BOT and BFCE Notes ($97.76 million); in the ABN swap, it was set at an amount ($80,779,000), equal to Kannex's 82.63 percent share of the combined total notional principal amount of the BOT and BFCE Notes. Likewise, in the BFCE swap, the principal amount of the amortizing leg ($9,831,661) was equal to 50/175, or 28.5 percent of the combined total issue price of the BOT and BFCE Notes ($34,410,814); in the ABN

swap, the principal amount of the corresponding leg was $28,433,655, an amount approximately equal to Kannex's 82.63 percent share of the combined total issue price of the BOT and BFCE Notes. If, as Beder concluded, the amortizing leg was worth more than then fixed notional leg in the BFCE swap, that asymmetry in value would necessarily have been magnified in the larger, but structurally identical, ABN swap. The second respect in which the swaps differed was that Merrill Capital occupied the position of the net creditor in the BFCE hedge swap but that of the net debtor in the ABN swap. The hedge swap between ABN and Kannex was in all respects identical to the hedge swap between Merrill Capital and ABN, except that ABN now assumed the position of net debtor.

The effect of the back-to-back hedge swaps would have been to transfer from Merrill Capital to ABN and from ABN to Kannex a portion of the value extracted from the partnership through the transaction spreads it was charged in the contingent payment sale. This transfer partly indemnified Kannex for its share of the partnership's economic loss.

By separate swap confirmations effective November 27, 1989, Merrill Capital agreed to pay ABN, and ABN agreed to pay Kannex, interest at the rate of LIBOR minus 25 basis points on a notional principal of $903,765, an amount that corresponded to Kannex's share of the 5/8 discount incurred by the partnership in the sale of the Citicorp Notes and origination of the LIBOR Notes. Following the distribution of the BFCE Notes to Southampton, the notional principal was reduced to $680,156. This revised amount represents the product of Kannex's then current percentage interest as reflected on a preliminary draft revaluation worksheet (87.06 percent) multiplied by the portion of the discount attributable to the BOT Notes retained by the partnership ($781,250). The documentation characterized these agreements as "swaps". This is a misnomer, however, because the payment obligations were unilateral. The parties' characterization reflects the fact that these "one-sided swaps" were negotiated

in conjunction with the back-to-back hedge swaps and were intended to complement them. Like the hedge swaps, the one-sided swaps had the effect of compensating Kannex for a loss that it would otherwise have borne in connection with the contingent payment sale.

We have previously discussed how the partnership chose to account for the 5/8 discount incurred in the contingent payment sale for financial and tax accounting purposes. Rather than recognizing this transaction cost, the partnership included it in the carrying cost of the LIBOR Notes. Although this method of accounting was calculated to result eventually in the allocation of all of the transaction cost to Kannex's partners, as long as recognition of the cost was deferred, the capital accounts of Kannex's partners were overstated, and Kannex's share of partnership income was understated. According to the revaluation worksheets, the partners' capital account balances as of the end of FYE 11/30/89, were restated at fair market value as follows:

Kannex	MLCS	Southampton	Total
$170,617,686	$603,976	$35,145,281	$206,366,943
(82.68%)	(0.29%)	(17.03%)	(100%)

Had the $1,093,750 discount been recognized and allocated, say, entirely to Southampton at this time, Kannex's pro rata interest in partnership assets and share of partnership income would have been .4402742 percentage points higher and Southampton's .4402742 percentage points lower:

Kannex	MLCS	Southampton	Total
$170,617,686	$603,976	$34,051,531	$205,273,193
(83.12%)	(0.29%)	(16.59%)	(100%)

This .4402742 percentage point discrepancy corresponds to Kannex's allocable share of the discount:

$205,273,193 x .4402742% = $903,765 = $1,093,750 x 82.63%.

Under the one-sided swaps, ABN received from Merrill Capital and Kannex received from ABN a return on this .4402742 percentage point discrepancy in the capital accounts. When the transaction cost was subsequently recognized in part and charged to Southampton's capital account upon the distribution of the BFCE Notes, the understatement of Kannex's capital account was partly corrected and the notional principal amount on which the one-sided swap payment obligations were based was accordingly reduced. This compensatory arrangement appears to be critical to an understanding of why ABN agreed to an accounting policy that caused the partners' capital accounts to misrepresent the agreed allocation of costs to Kannex's detriment.

An unexecuted version of the one-sided swap between Merrill and ABN ran for a 5-year period coterminous with the hedge swap. In the executed agreements, the termination date was December 1, 1990. At the expiration of this term, the one- sided swap between ABN and Kannex was extended for a second year. There is no record of any similar extension of the corresponding one-sided swap between ABN and Merrill.

Through another series of swaps arranged by ABN New York, Kannex effectively eliminated its risk of loss and opportunity to gain from allocations of the Yield Component of the Colgate debt. The counterparty in these swaps was ABN Cayman Islands, but it was den Baas and others at ABN New York who executed the transactions on behalf of both counter parties. With respect to each issue of fixed-rate Colgate debt acquired by the partnership, Kannex entered into a fixed-for-floating interest rate swap on a notional principal amount corresponding to the dollar amount of Kannex's exposure to interest rate risk on the debt. Whenever Southampton elected to adjust the Yield Component sharing ratio or Kannex's partnership interest changed, the notional principal amounts of Kannex's swaps were adjusted to cover the amount of its exposure. The net effect for Kannex resembled an investment in a portfolio of LIBOR-based assets

whose value would not vary in relation to the value of its LIBOR-based liability under the Revolving Credit Agreement.

The swaps with ABN Cayman Islands effectively offset Kannex's losses and gains from the intrinsic treasury risk of the Colgate debt held by the partnership. The swaps also offered Kannex the opportunity to profit from the spread risk of the Colgate debt. Kannex was required to pay interbank swap rates on its swaps. The fixed interbank swap rates were determined by adding a spread to the prevailing yields on comparable Treasury securities. For every piece of Colgate debt purchased, there was a referenced Treasury rate. To the extent that the yields on the partnership's Colgate debt exceeded these rates, Kannex kept the difference. ABN profited from the spreads that it earned in hedging its swap positions through coordinated trading of Treasury securities or futures, or through matching swaps with third parties.

In order for the hedging of Kannex's risks to be both effective and lucrative, the selection of Treasury securities used in the construction of hedge positions had to be consistent with the selection of Treasury securities used in the revaluation of the Colgate debt within the partnership. Aware of these hedging operations, Merrill accommodated them by consulting with ABN on the valuation of ACM's Colgate debt whenever changes in value were likely to affect Kannex's capital accounts. Thus, one Merrill internal memorandum described the procedures for an upcoming revaluation:

> Since Kannex must actually trade Treasuries based upon the Base Treasury yields, Kannex would determine yields on Base Treasuries for each Note. These yields, along with previously determined spreads, are used by ML to set prices of each Note.

Under its Revolving Credit Agreement with Kannex, ABN reserved the right to sell participations, provided that it would remain solely responsible for performance of the

obligations owed to Kannex under the Agreement.[18] Beginning in the fall of 1989, ABN offered a number of banks the opportunity to participate in its loans to Kannex as well as to other special purpose corporations that ABN Trust had organized for section 453 partnerships. The participations ABN proposed were short-term and renewable. ABN would guarantee an interest rate of LIBOR plus 35 basis points or 50 basis points. ABN would possess the exclusive right to enforce the loan.

ABN's relationship to Kannex was a source of some confusion. An internal memorandum of Banco di Roma outlining the syndication proposal described ABN as a "shareholder in Kannex together with another major U.S. Corporation". In the attempt to reassure prospective investors that their principal would be secure, den Baas went further than the terms of the formal Participation Agreement in defining ABN's position in the arrangements: "Since there is neither a scheduled interest payment on the notes held in the portfolio nor a principal repayment you would look even more to ABN to take you out at the maturity date of the loan". Within Banco di Roma, the participation was recommended for approval with the following explanatory gloss: "The repayment source of our advance is the committed facility provided by ABN through its Curacao or Grand Cayman Branch." The memorandum concludes: "Taking into consideration: The de facto guarantee of ABN, * * * we recommend your authorization to participate". An internal credit proposal of Banco Espirito Santo E Comercial De Lisboa (Banco Espirito Santo) reflects a similar understanding. Beside the heading "Guarantor", the following explanation appears: "Subsidiary of ABN will borrow against a firm takeout at maturity". Considering its reliance on the repeated participation of a small group of banks to sustain its involvement in numerous section 453 partnerships, it is not

---

[18] Details of the syndication of the loan to Kannex and details of Kannex's ultimate liquidation, which are related hereafter, shed light on the character of the relationship between Kannex and ABN.

surprising that ABN would wish to imply, and that the investors would be prepared to infer, that they could look to ABN for repayment.

Generale Bank, Banco Espirito Santo, and Banco di Roma acquired participations in Kannex's loan in amounts between $25 million and $75 million. All participations were repaid by July 1991. The loan from ABN Cayman Islands was ultimately repaid out of the liquidating distribution that Kannex received at the end of November 1991. Owing to the preferred return that Kannex received from Southampton and appreciation of Colgate debt as a result of the decline in interest rates, there was a sizeable surplus remaining after repayment of the loan, as shown on Kannex's balance sheet for the period ended November 30, 1991. Kannex did not retain this surplus. Kannex also did not distribute this surplus to its nominal shareholders when Kannex was liquidated shortly thereafter.

Following the redemption, Kannex's swaps with ABN were terminated. The benefit that Kannex had enjoyed from a fall in interest rates for purposes of the valuation of its partnership interest was offset by the appreciation of the fixed-rate cash flows that it was obligated to pay relative to the floating rate cash flows it was entitled to receive under the Colgate debt swaps. Kannex owed ABN Cayman Islands $3,180,453. For reasons that the record does not disclose, the amount Kannex paid was higher by $1,655,000, and this excess was credited to den Baas' Financial Engineering Group. The back-to-back hedge swaps between Kannex and ABN New York and ABN New York and Merrill Capital were also terminated at the same time. Although the terms of the swaps were identical, for reasons not disclosed in the record, the termination payment that ABN New York made to Kannex was $500,000 less than the termination payment that was received from Merrill Capital. Kannex's balance sheet for the period ended January 27, 1992, shows remaining stockholder's equity of $17,278. Of this amount, $6,000 was attributable to the loans that Kannex had originally made to

the foundations to finance their contributions and the rest may have been attributable to a capitalized loan from ABN. All the proceeds of Kannex's participation in ACM were, in one way or another, remitted to ABN. Liquidation procedures commenced in the following month.

OPINION

ACM structured its sale of the Citicorp Notes to fall within the contingent payment sale provisions of section 15a.453-1(c), Temporary Income Tax Regs., 46 Fed. Reg. 10711 (Feb. 4, 1981). On November 3, 1989, ACM purchased $205 million of Citicorp Notes, and, 3 weeks later, it sold $175 million of the notes to BOT and BFCE for $140 million in cash and eight LIBOR Notes with a present value of $35 million. The LIBOR Notes did not provide for the payment of a stated principal amount. For FYE 11/30/89, ACM applied the ratable basis recovery rules of section 15a.453-1(c), Temporary Income Tax Regs., *supra*, recovering only $29,250,761 of its basis in the notes and recognizing $110,749,239 of capital gain. ACM allocated $91,516,689 of the gain to Kannex, an entity that was not subject to U.S. tax.

In FYE 12/31/91, after ACM redeemed Kannex's partnership interest, ACM sold the BOT LIBOR Notes to BFCE for $10,961,581, and, under section 15a.453-1(c), Temporary Income Tax Regs., *supra*, recognized a capital loss of $84,997,111. ACM allocated $84,537,479 of this loss to Colgate and Southampton.

We must decide whether ACM's planned sequence of investments and dispositions should be respected for tax purposes. We sometimes refer to ACM's planned sequence of investments and dispositions calculated to create the capital losses that were the objective of the CINS transaction as the "section 453 investment strategy".

1. Mechanics of a Contingent Payment Sale

Section 15a.453-1(c), Temporary Income Tax Regs., *supra*, provides installment sale treatment for "contingent

payment sales". A "contingent payment sale" is "a sale or other disposition of property in which the aggregate selling price cannot be determined by the close of the taxable year in which such sale or other disposition occurs." *Id.* Where the sales agreement provides for no maximum aggregate selling price but fixes the period over which payments may be received, the temporary regulations generally require the seller to allocate an equal portion of its basis in the sale property to each of the taxable years in which payments may be received. Sec. 15a.453-1(c)(3), Temporary Income Tax Regs., 46 Fed. Reg. 10714 (Feb. 4, 1981). The seller computes its income for each year in respect of a contingent payment sale as the excess of the payments received in that year over the portion of the basis allocated to that year. *Id.*

The temporary regulations anticipate that application of the general rule for basis recovery will create distortions of income in some cases, and they provide certain remedies. The Commissioner may require an alternate method of basis recovery if the Commissioner finds that the general rule will "substantially and inappropriately accelerate recovery of basis." Sec. 15a.453-1(c)(7)(iii), Temporary Income Tax Regs., 46 Fed. Reg. 10716. Conversely, if application of the general rule "will substantially and inappropriately defer recovery of basis," the taxpayer may request an alternate method, but the Commissioner is not granted explicit authority by the temporary regulations to require the use of an alternate method in that situation. Sec. 15a.453-1(c)(7)(ii), Temporary Income Tax Regs., 46 Fed. Reg. 10716. The Commissioner may prescribe an alternate method if she determines that the taxpayer's method of accounting with respect to the sale does not "clearly reflect income". Sec. 446(b). In general, the Commissioner has broad discretion to determine whether an accounting method clearly reflects income. See *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522, 532-533 (1979); *Commissioner v. Hansen*, 360 U.S. 446, 467 (1959); *Ferrill v. Commissioner*, 684 F.2d 261, 264 (3d Cir. 1982), affg. T.C. Memo. 1979-501; *Hudson v. Commissioner*, T.C. Memo. 1996-106. A taxpayer's method

of accounting does not clearly reflect income when it does not represent "economic reality". See *Prabel v. Commissioner*, 882 F.2d 820, 826-827 (3d Cir. 1989), affg. 91 T.C. 1101 (1988). In this case, the Commissioner has not exercised her discretion by raising the clear reflection of income issue in her pleadings or in her brief.

2. Economic Substance

a. Introduction

In his opening statement, petitioner's counsel aptly characterized the role of economic substance in this case: "[B]oth parties agree that the question of substance is critical to the outcome. At the most fundamental level, this case is about very different views of commercial reality and very different views of the tax law's concept of substance."

ACM sold the $175 million aggregate principal amount of Citicorp Notes for $140 million in cash and eight LIBOR Notes, and, in connection therewith, reported a capital gain for FYE 11/30/89 and a corresponding capital loss for FYE 12/31/91. Respondent eliminated this gain and disallowed the loss. Respondent determined that the underlying transactions should not be given effect for Federal income tax purposes because it was tax-driven and devoid of economic substance. Respondent argues that the formation of the partnership and its activities during the relevant years were merely prearranged steps in a contrived, tax-motivated transaction that was carried out in accordance with Merrill's pursuit of approximately $100 million in taxable losses for Colgate. Respondent states that the liability management functions ascribed to ACM in documentation prepared by Merrill and Colgate were spurious. Respondent alleges that the structured transactions in which the LIBOR Notes were created and sold formed a "tax shelter market" that was controlled by Merrill, and that was operated in accordance with unwritten understandings. Respondent asserts that this "market" was supported by subsidizing the participating banks, as well as by circular payment flows and premature terminations that insulated the banks from a material risk with respect to the

LIBOR Notes. Respondent alleges that structured transactions involving substantially the same patterns, timetables, and many of the same banks were involved in the issuance and sale of LIBOR Notes for each of the other section 453 partnerships.

Petitioner's account of the CINS transaction bears little resemblance to respondent's view. Petitioner argues that ACM was rationally designed to address genuine liability management needs. Petitioner alleges that all partnership transactions were negotiated at arm's length, priced at fair market value, conducted in accordance with standard commercial practices, and had practical effects wholly apart from their tax consequences. Petitioner asserts that the partnership and each of its partners had reasonable prospects for profit and risk of loss. Petitioner contends that, in arranging the structured transactions, Merrill acted in the customary role of a market maker, bringing counterparties together on terms that suited their respective needs. Petitioner argues that the swaps are irrelevant to the legal analysis because ACM was not a party to any of the swaps.

Following our review of the record, with due regard to our view and perception of the witnesses, we do not find any economic substance in the section 453 investment strategy.[19] We are convinced that tax avoidance was the reason for the partnership's purchase and sale of the Citicorp Notes. We do not suggest that a taxpayer refrain from using the tax laws to the taxpayer's advantage. In this case, however, the taxpayer desired to take advantage of a loss that was not economically inherent in the object of the sale, but which the taxpayer created artificially through the manipulation and abuse of the

---

[19] We need not, and do not, delve into the appropriateness of reporting the transaction on the installment method. We are compelled to note, however, that the installment method reports income, sec. 453(a), and the partnership sold the Citicorp Notes for consideration equal to the notes' purchase price.

tax laws. A taxpayer is not entitled to recognize a phantom loss from a transaction that lacks economic substance.

In analyzing whether the CINS transaction had economic substance, we have been mindful that for some businesses there is little, if any, meaningful difference between an improvement in financial performance achieved by cutting operating expenses and one that results from reducing taxes. Both reductions improve the financial statement. The tax law, however, requires that the intended transactions have economic substance separate and distinct from economic benefit achieved solely by tax reduction. The doctrine of economic substance becomes applicable, and a judicial remedy is warranted, where a taxpayer seeks to claim tax benefits, unintended by Congress, by means of transactions that serve no economic purpose other than tax savings. *Yosha v. Commissioner*, 861 F.2d 494, 498-499 (7th Cir. 1988), affg. *Glass v. Commissioner*, 87 T.C. 1087 (1986); see also *Estate of Thomas v. Commissioner*, 84 T.C. 412, 432-433 (1985), and the cases cited therein.

Our conclusion is supported by well-settled judicial jurisprudence. In the seminal case of *Gregory v. Helvering*, 293 U.S. 465, 469 (1935), the Court recognized an individual's right to decrease her taxes in any way permitted by law. As held by the Court, however, this right is not absolute. The Court held that a reorganization that met the literal requirements of the Code would not be respected for Federal income tax purposes because "what was done, apart from the tax motive, was [not] the thing which the statute intended". The Court stressed that the transaction had "no business or corporate purpose", but was "a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character". *Id.*

In the 60 years since the U.S. Supreme Court first expounded this doctrine of "business purpose", the doctrine's application has proved a perennial challenge to the courts to set boundaries between acceptable tax planning and abuse, while taking into account the importance of maintaining

public confidence in the integrity of the tax system. In *Knetsch v. United States*, 364 U.S. 361 (1960), for example, the Court applied the *Gregory v. Helvering* case to disallow an interest deduction. In so doing, the Court stated that "there was nothing of substance to be realized * * * from this transaction beyond a tax deduction." *Knetsch v. United States, supra* at 366. Similarly, in *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978), the Court stated that economic substance is a necessary requirement of any transaction. In *Frank Lyon*, the Court looked to "the objective economic realities of a transaction rather than to the particular form the parties employed", *id.* at 573, and stated that the Government should honor the allocation of rights and duties effectuated by the parties "where, as here, there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached", *id.* at 583-584.

The Court of Appeals for the Second Circuit applied an economic substance analysis in *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966), affg. 44 T.C. 284 (1965). In that case, Mrs. Goldstein won the Irish Sweepstakes. In an attempt to shelter her winnings from tax, she borrowed from two banks and invested the loan proceeds in Treasury notes. The loans required her to pay interest at 4 percent, while some Treasury notes yielded one-half percent and others yielded 1-1/2 percent. Her financial advisers estimated that these transactions would produce a pretax loss of $18,500 but a substantial after-tax gain. This Court sustained the Commissioner's disallowance of the interest deductions. In affirming the decision of this Court, the Second Circuit stressed that this Court had found that Mrs. Goldstein's purpose in entering into the loan transactions " 'was not to derive economic gain or to improve here [sic] beneficial interest; but was *solely* an attempt to obtain an interest deduction as an offset to her sweepstakes winnings.' " *Id.* at 738 (quoting *Goldstein v. Commissioner*, 44 T.C. at 295). The

Second Circuit stated further that the loan arrangements did not "have purpose, substance, or utility apart from their anticipated tax consequences", and that the transactions had no "realistic expectation of economic profit". *Id.* at 740.

The *Goldstein* case marks an important step in the development of the economic substance doctrine.[20] Unlike many purported tax shelters, the tax-motivated transactions in that case were not fictitious. *Goldstein v. Commissioner, supra* at 737-738. They were real and conducted at arm's length.[21] Mrs. Goldstein's indebtedness was enforceable with full recourse and her investments were exposed to market risk. Yet, the strategy was not consistent with rational economic behavior in the absence of the expected tax benefits. Other courts have applied the teaching of *Goldstein* in varied settings. In *Sheldon v. Commissioner*, 94 T.C. 738 (1990), for example, this Court analyzed the financial transactions in issue there in a manner similar to that employed in *Goldstein*. The Court first determined that the transactions at issue were real, rather than fictitious. The Court then evaluated economic substance, stating that "the principle of * * * [*Goldstein*] would not, as petitioners

---

[20] In *United States v. Wexler*, 31 F.3d 117, 123 (3d Cir. 1994), the Court of Appeals for the Third Circuit described *Goldstein* as "[t]he seminal sham transaction case".

[21] We believe the CINS transaction also was real and not fictitious. In *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89 (4th Cir. 1985), affg. in part and revg. in part 81 T.C. 184 (1983), the Court of Appeals for the Fourth Circuit concluded that a transaction was a sham because it lacked business purpose and economic substance. In *Lerman v. Commissioner*, 939 F.2d 44, 53-54 (3d Cir. 1991), affg. *Fox v. Commissioner*, T.C. Memo. 1988-570, the Court of Appeals for the Third Circuit adopted the Second Circuit's definition of a sham transaction as "a transaction that 'is fictitious or * * * has no business purpose or economic effect other than the creation of tax deductions.' " (quoting *DeMartino v. Commissioner*, 862 F.2d 400, 406 (2d Cir. 1988), affg. 88 T.C. 583 (1987)). The CINS transaction was not a sham in the sense that it was fictitious but it was a sham in the sense that the sec. 453 investment strategy lacked economic substance.

suggest, permit deductions merely because a taxpayer had or experienced some de minimis gain." *Id.* at 767. The Court held that a transaction resulting in gain that was "infinitesimally nominal and vastly insignificant when considered in comparison with the claimed deductions" had no economic substance.[22] *Id.* at 768. The Court noted that "[i]f the transactions had been fully offset, straddled, or hedged to obviate the possibility of any loss or gain, the form of the transaction could have been more readily attacked by respondent." *Id.* Accord *Merryman v. Commissioner*, 873 F.2d 879, 881 (5th Cir. 1989), affg. T.C. Memo. 1988-72; *Levin v. Commissioner*, 87 T.C. 698, 699, 728 (1986), affd. 832 F.2d 403 (7th Cir. 1987); *Julien v. Commissioner*, 82 T.C. 492, 509 (1984).

In *Lerman v. Commissioner*, 939 F.2d 44 (3d Cir. 1991), affg. *Fox v. Commissioner*, T.C. Memo. 1988-570, the Court of Appeals for the Third Circuit analyzed the economic substance doctrine. In *Lerman*, the taxpayers claimed to be commodities dealers and sought to deduct losses resulting from their option-straddle transactions. *Id.* at 45. The Third Circuit held that the transactions were "shams, devoid of economic substance, and thus any losses generated thereby cannot be the basis for deductions." *Id.* at 56. The court noted that "*Per Gregory v. Helvering* * * * it is settled federal tax law that for transactions to be recognized for tax purposes they must have economic substance." *Id.* at 52.

More recently, the Third Circuit reiterated that "[t]he general rule on sham transactions in this circuit is well-established: 'If a transaction is devoid of economic substance * * * it simply is not recognized for federal taxation purposes, for better or for worse. This denial of recognition means that a

---

[22] The Court of Appeals for the Third Circuit commented that "*Sheldon* actually expanded the sham transaction doctrine because it barred interest deductions from arrangements motivated by tax benefits even if the transactions could have generated a profit." *United States v. Wexler*, 31 F.3d 117, 124 n.9 (3d Cir. 1994).

sham transaction, devoid of economic substance, cannot be the basis for a deductible loss.' " *United States v. Wexler*, 31 F.3d 117, 122 (3d Cir. 1994) (quoting *Lerman v. Commissioner*, *supra* at 45). In *Wexler*, the taxpayer claimed deductions resulting from financial arrangements known as "repo to maturity" transactions. *Id.* at 118. The taxpayer argued that the economic substance doctrine did not apply to the deduction of interest payments pursuant to section 163 if the taxpayer's obligation to pay the interest is binding and enforceable. *Id.* at 122. The Third Circuit analyzed a series of related cases and noted that the key requirement that permeated each of those cases was that the financial transaction be "economically substantive". *Id.* at 127 (emphasis omitted). The Third Circuit stated that "transactions with no economic significance apart from tax benefits lack economic substance." *Id.* at 124.

The "principle laid down in the Gregory case is not limited to corporate reorganizations, but rather applies to the federal taxing statutes generally." *Weller v. Commissioner*, 270 F.2d 294, 297 (3d Cir. 1959), affg. *Emmons v. Commissioner*, 31 T.C. 26 (1958) and *Weller v. Commissioner*, 31 T.C. 33 (1958); see also *Knetsch v. United States*, 364 U.S. 361 (1960) (interest deduction); *Higgins v. Smith*, 308 U.S. 473 (1940) (loss deduction on sale to wholly owned corporation); *Weyl-Zuckerman & Co. v. Commissioner*, 232 F.2d 214 (9th Cir. 1956), affg. 23 T.C. 841 (1955) (mineral rights transferred to a wholly owned subsidiary); *Braddock Land Co. v. Commissioner*, 75 T.C. 324 (1980) (shareholders-employees' forgiveness of accrued salaries, bonuses, and interest owed by corporation in complete liquidation); *David's Specialty Shops v. Johnson*, 131 F. Supp. 458 (S.D.N.Y. 1955) (affiliated corporations). The tax statutes apply only "to transactions entered upon for commercial purposes and 'not to * * * transactions entered upon for no other motive but to escape taxation.' " *Weller v. Commissioner*, 270 F.2d supra at 297 (quoting *Commissioner v. Transport Trading & Terminal Corp.*, 176 F.2d 570, 572 (2d Cir. 1949), revg. 9 T.C. 247 (1947)). Thus, transactions

will only be recognized for tax purposes if there is some "tax-independent purpose" for the entire transaction. See *Sheldon v. Commissioner*, *supra* at 759. Only after we conclude that a transaction has economic substance will we consider the transaction's tax consequences under the Code. See *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89, 95 (4th Cir. 1985), revg. on a different issue 81 T.C. (1983).

Whether a transaction has economic substance is a factual determination. *United States v. Cumberland Pub. Serv. Co.*, 338 U.S. 451, 456 (1950). Key to this determination is that the transaction must be rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and useful in light of the taxpayer's economic situation and intentions. Both the utility of the stated purpose and the rationality of the means chosen to effectuate it must be evaluated in accordance with commercial practices in the relevant industry. *Cherin v. Commissioner*, 89 T.C. 986, 993-994 (1987). A rational relationship between purpose and means ordinarily will not be found unless there was a reasonable expectation that the nontax benefits would be at least commensurate with the transaction costs. See *Yosha v. Commissioner*, 861 F.2d 494, 498 (7th Cir. 1988), affg. *Glass v. Commissioner*, 87 T.C. 1087 (1986) (explaining the teaching of *Goldstein*); cf. *Seykota v. Commissioner*, T.C. Memo. 1991-234, amended T.C. Memo. 1991-541. "[D]eliberately to incur an expense greater than the expected gain--to pay 4 percent for the chance to make 2 percent--is the antithesis of profit-motivated behavior; such a transaction lacks economic substance." *Yosha v. Commissioner*, *supra* at 498.

Since the overall transaction must have economic substance for the Federal tax statutes to apply, we first consider whether the section 453 investment strategy had economic substance. Petitioner concedes that the section 453 investment strategy was tax motivated, but argues that tax-independent considerations informed and justified each step of the strategy. Petitioner explains ACM's investment in the Citicorp Notes as follows: "[T]he ACM partners believed the

Citicorp Notes offered a reasonable return on ACM's investment until such time as ACM might require cash for the purchase of Colgate debt". The Citicorp Notes were sold after 24 days to enable the partnership to invest in Colgate debt and LIBOR Notes. Petitioner argues that the investment in LIBOR Notes had two purposes. First, unlike an interest rate swap, which ACM could have used as an alternative hedging instrument, the LIBOR Notes provided the partners with an investment return. According to petitioner, "there was a realistic prospect that ACM would have made a profit on the LIBOR Notes." Petitioner contends that ACM disposed of the BFCE Notes and the BOT Notes when the hedging protection was no longer needed. Second, ACM invested in LIBOR Notes because it was "within the four corners of the partnership to operate as a hedge".

In light of each of these stated purposes, we examine the economic substance of the section 453 investment strategy.

b. Profit

The following colloquy at trial sheds some light on how Colgate's management arrived at the conclusion that the section 453 investment strategy promised a reasonable return and realistic prospect for profit. Pohlschroeder was the witness.

> Q: In determining whether you should cast a vote or recommend that the partnership purchased (sic) the Citicorp Notes, did you take into account the transaction cost that would be incurred upon the sale of those notes?
>
> A: It was known that there were transaction costs.
>
> * * * * * * * *
>
> I really didn't know at that time what that exact amount was going to be, and basically, the initial part was just to get a reasonable return on the Citicorp Notes and make sure that the cash that we had received as a contribution was invested as quickly as possible.

Q: So, in determining whether you were going to earn a reasonable return, did you take into account the transaction costs that might be incurred upon the sale?

A: Not at that point. It was just basically an investment decision.

Q: So you did not compare those transaction costs that might have to be incurred upon the sale of the Citicorp note to the transaction cost on other instruments?

A: That is right, yes.

When the Partnership Committee formally authorized the purchase of the Citicorp Notes, Merrill informed Colgate that the section 453 investment strategy would result in transaction costs of between $2.3 and $3.1 million on a pretax present value basis, of which $1.3 to $2.0 million would be incurred in the contingent payment sale. The cash contributions that had to be "invested as quickly as possible" in Citicorp Notes yielding 8.78 percent in order for the partners to earn a reasonable return were already earning 8.75 percent in an ABN deposit account before the notes were acquired.

That Colgate's treasury department did not attach importance to the relative costs of the section 453 investment strategy is particularly significant because Colgate would bear both the transaction and remarketing costs. Pepe testified concerning the mutual understanding with respect to the five-eighths discount incurred in connection with the contingent payment sale:

> The transaction was performed and put together, organized, on behalf of Colgate-Palmolive; therefore, the partners understood that the cost related to setting the transaction up should be borne by Colgate-Palmolive, whether that's through the partnership or through one of its partners.

The allocation of these costs to Colgate was accomplished by including them in the value at which the LIBOR Notes were carried on the partnership books and in the partners' capital accounts. When the BFCE Notes were distributed to Southampton, the other partners' allocable shares of these costs were charged to Southampton's capital account. When Southampton, Colgate and, to a nominal extent, MLCS acquired Kannex's partnership interest, they effectively purchased Kannex's share of the BOT Notes at a price that included Kannex's allocable share of these costs. Because the LIBOR Notes were acquired for Colgate's benefit, the partners provided that the remarketing costs would be borne almost entirely by Colgate as well. This was accomplished by selling the LIBOR Notes only after Colgate, Southampton and, to nominal extent, MLCS, had acquired all of Kannex's interest in them.

Kannex's interest in the BOT Notes could be acquired by Colgate alone or together with MLCS. If only Colgate purchased Kannex's interest, Colgate would bear all origination and remarketing costs allocable to that interest. If Colgate and MLCS purchased or redeemed Kannex's interest pro rata, each would bear a pro rata share of these costs. Acquisition of Kannex's interest by a combination of these methods would result in the sharing of these costs in some intermediate ratio. This was the approach that the parties actually adopted, but the evidence suggests that this decision may not yet have been made in November 1989. Nevertheless, it is unlikely that Colgate would have acquired any less than a pro rata share of Kannex's interest, since the opportunity cost of foregoing valuable tax benefits would have been too great.[23] The nontax benefits of

---

[23] The BOT Notes had a tax basis of $104.467 million. Even if we assume that interest rates rose by 500 basis points, causing an increase in the cost to acquire Kannex's interest in the notes from $20.955 million ($25.361 million x .8263) to $29.283 million ($35.439 million x .8263) and a decrease in the taxable loss recognizable on the sale of Kannex's interest in the notes from $66.842 million (($104.467 million - $23.574 million) x .8263) to $58.622 million (($104.467 million - $33.521 million) x .8263), each $1 that Colgate paid to acquire Kannex's interest would still produce more than $2 of taxable losses.

holding and selling Kannex's share of the notes would be shared in the same ratio as the costs associated with that share, but, in all events, these benefits would necessarily be less than the costs.

If the section 453 investment strategy was economically justifiable in part on the basis of expected pretax returns, and the partners understood that Colgate, as the beneficiary of the strategy, would bear virtually all transaction costs, then the strategy must have provided Colgate a realistic possibility of recovering these costs for the section 453 investment strategy to be deemed profitable. We examined the proposition that Colgate could reasonably have expected to recover the transaction costs of the strategy through cash flows from the LIBOR Notes, and we now set forth our analysis with respect thereto.

Colgate's return was a function of two variables. First, the credit quality of the issuers of the LIBOR Notes could have affected Colgate's returns. The possibility of benefitting from a credit improvement, however, was negligible. BFCE's rating was AAA and could not have improved. BOT was rated AA. If an improvement in BOT's credit could have increased the sale price of the notes, then one would expect that the difference between the banks' respective ratings would have affected the pricing of the notes at issuance. It had no effect.

The second and more important factor was interest rates. Based on its assumption that future interest rates would equal the levels predicted by the yield curve used to price the LIBOR Notes at their issuance, Merrill estimated that the issue price for the notes exceeded by approximately $1.3 million the bid price at which the notes could be sold to a third party. Hence, the partnership, and ultimately Colgate, would almost certainly lose money.

One must wonder what were the nontax benefits that the partnership hoped to achieve through its acquisition of the notes at that price level. Interest rates would have had to rise by at least 400-500 basis points, to a level of 13 percent or more, soon after the partnership acquired the LIBOR Notes

and be expected to remain at that level throughout the 5-year life of the notes in order for Colgate to earn a sufficient return from the notes to cover the transaction costs of the section 453 investment strategy. Had the partners' economic arrangement contemplated a pro rata allocation of these costs, Colgate still could not have earned a profit on a net present value basis unless interest rates exceeded their expected levels, but a much smaller increase would have been sufficient to break even.

We reviewed historical data to assess the likelihood that 3-month LIBOR would have risen by the requisite amount for Colgate to break even. The record includes published records of market interest rates extending back to January 1984. There are 71 observations of 3-month LIBOR as of the first day of each month between January 1984 and November 1989. Not one of the 71 monthly quotations is 300 basis points or more above the quotations for the 1 to 6 previous months. Only three of the quotations represent a level 200 basis points or more above any quotations during the previous 6 months. There is no month for which 3-month LIBOR was above 12.13 percent. It reached or exceeded 11 percent in 6 months, all in mid-1984. In 30 months, it fell within the range of 8 to 9.99 percent, and it fluctuated between 10.31 and 8.56 percent during the first 11 months of 1989. The longest that 3-month LIBOR remained at or above 10 percent was 9 consecutive months in 1984. Thereafter, the longest period was 2 consecutive months in early 1989. In the late summer and early autumn of 1989, Colgate's treasury department confidently expected that interest rates would follow a downward trend for the foreseeable future.

Colgate could not have achieved a non-negative net present value under any reasonable forecast of future interest rates. A major war, an oil crisis, a resurgence of double digit inflation or other economic catastrophe might have been capable of inducing a sudden rise in interest rates by 400-500 basis points and might perhaps have sustained such levels for a period of months or years. But nothing in the record

suggests that anyone involved in planning the section 453 investment strategy anticipated, or had any reason to anticipate, the extraordinary economic conditions which would have been necessary in order to make Colgate's investment in the LIBOR Notes profitable.

Appreciation of the LIBOR Notes was not the only source of potential profit from the section 453 investment strategy. Petitioner and its experts contend that some or all of the transaction costs of the strategy could have been recovered out of returns from the Citicorp Notes. They identify three sources of potential profit: (1) Gain on the sale of the Citicorp Notes attributable to an improvement in Citicorp's credit, (2) gain attributable to an increase in the commercial paper rate to which the coupon on the notes was linked, and (3) accumulation of interest income over the period the partnership held the notes.

With respect to petitioner's first claim that an improvement in Citicorp's credit could produce a profit, petitioner states that "ACM's exposure to Citicorp's credit was real, not theoretical": There was a significant risk that Citicorp's credit could deteriorate, but a significant possibility of improvement as well. The Citicorp Notes were rated AA by Standard & Poors and A1 by Moody's, which implies that there was some room for improvement in the issuer's credit quality. Data for the 5-year period ending in December 1991 confirm many instances in which the credit spread on publicly traded Citicorp debt declined by large amounts over short periods of time. To conclude from this that there was a reasonable possibility that ACM could have sold the Citicorp Notes at a price above par would not be warranted, considering the terms of the structured transaction in which they were sold.

Under the terms of the basis swap between Merrill and the purchasing banks, Merrill had a right to call the Citicorp Notes at a strike price equal to their par value. This option was exercisable on any payment date and the step-up in the amount of Merrill's payment obligations under the basis swap

after 3 months effectively guaranteed that Merrill would exercise the option unless Citicorp's credit quality had substantially declined. Internal documents of BOT and BFCE indicate that both banks expected Merrill to purchase the notes from them within 1 to 3 months under this arrangement. Even if Citicorp's credit quality had improved over the period that ACM held the notes, it is unlikely that the banks would have been willing to pay any more than par for them, since all the increase in the value of the notes would only be appropriated by Merrill. It appears from the BOT and BFCE documents that the terms for Merrill's call option had already been worked out, along with most of the other details of the transaction structure, within 1 week of ACM's acquisition of the Citicorp Notes. Thus, Merrill designed the Citicorp Note transactions in a manner that effectively left no opportunity for ACM, or Colgate, to benefit from an improvement in Citicorp's credit. We reject petitioner's first contention.

Turning to petitioner's second claim that the Citicorp Notes, as floating rate notes (FRN's), could increase in value by way of an increase in the related commercial paper rate, we note that the value of a FRN is generally invariant to changes in market interest rates. Indeed, this is the source of its appeal to investors. Because the coupon payable on the Citicorp Notes was reset each month at the current commercial paper rate, the value of the notes should not have deviated significantly from par. This appears to have been the understanding of those who planned and approved the Citicorp Note investment. A memorandum of ACM's accountants recites that "[a]s per explanation of Mr. Hans Pohlschroeder * * * the Citicorp Notes were floating rate notes * * * and can thus by definition not fluctuate in value because of changes in interest rates as the interest on the notes follows these changes". Under the partnership's Accounting Policies, the Citicorp Notes were treated as a cash equivalent for this reason.

According to petitioner, this understanding is subject to significant qualifications. Petitioner relies on the observations

of one of its experts, Joseph Grundfest (Grundfest) of Stanford University. Grundfest notes that the decision to purchase a FRN locks in a return tied to a specified floating rate index. There are several indices, LIBOR, treasury bill, Federal funds rates, etc., and their relationship is not stable over time. Payments on FRN's can vary substantially depending on the choice of the underlying index. Grundfest goes on to cite actual examples of significant discrepancies between certain floating rate indices that occurred during and around the years at issue.

We cannot quarrel with these observations. How much significance we should attach to the potential for such market discrepancies as a basis for a reasonable expectation of profit is another matter. FRN's are commonly used by investors as a substitute for short term money market instruments such as certificates of deposit (CD's). Historical interest rate data introduced in evidence confirm that changes in the 1-month commercial paper rate and CD rate are not perfectly correlated. Over the 71 months from January 1984 to November 1989, the two rates fluctuated, but generally remained within 15 basis points of one another. In only 4 months did the difference between them equal or exceed 40 basis points. During the period that ACM planned to hold the Citicorp Notes, the coupon would be reset only once. The historical data provide no basis for concluding that there was any significant likelihood that an appreciable change in the historical relationship between the 1-month commercial paper rate and other money market indices would have arisen on this single occasion. Accordingly, we are not persuaded by petitioner's claim that it expected the Citicorp Notes to increase in value by way of an increase in the related commercial paper.

We now consider petitioner's third and final claim that it had a high probability of recovering its transaction costs through accumulation of interest income on the Citicorp Notes over the period that petitioner held the notes. Petitioner and its experts take the position that a substantial portion of

the transaction costs of the section 453 investment strategy were likely to be recovered dollar-for-dollar through the accumulation of interest income from the Citicorp Notes: The longer ACM held the notes, the greater the amount of interest it received from Citicorp, and, all other things being equal, the greater the likelihood of earning a profit. ACM could reasonably have expected to receive, and did receive, about $1.2 million in interest on the Citicorp Notes over the 24 days that it held them. Colgate's share of this income (through Southampton) was about 17 percent (approximately $204,840), significantly less than the transaction costs incurred in the CINS transaction.

The initial coupon on the Citicorp Notes offered a three basis point advantage over the yield that the partners' contributions were currently earning in an ABN deposit account. Had the Citicorp Notes retained that yield advantage for the duration of the 24-day holding period, they would have provided ACM with $3,500 more income, of which Colgate's share would be about $600. Another alternative investment for the partnership cash was a portfolio of short-term money market instruments like those which it acquired with the $140 million cash proceeds of the contingent payment sale and which matured 1 week later on the settlement date for the purchase of the Colgate debt. These commercial paper issues provided yields ranging from 8.15 to 8.20 percent, 45-50 basis points less than the 8.65-percent coupon payable on the remaining $30 million Citicorp Notes for the second reset period. This yield differential was likely to have been attributable in part to a declining trend in short-term interest rates throughout the fall of 1989, which the coupon rate on the Citicorp Notes reflected only after a lag. Assuming, however, that at the time ACM acquired the Citicorp Notes they would have provided the same 50 basis point advantage over alternative commercial paper investments over the 24-day holding period, this advantage would have resulted in $58,000 more income for the partnership and less than $10,000 more income for Colgate. In short, any yield advantage that the Citicorp Notes may

have offered over less costly alternatives would not significantly have improved Colgate's prospects for recovering the $2-3 million present value of transaction costs that it expected to incur in connection with the section 453 investment strategy. Accordingly, we reject petitioner's third contention.

We conclude that the partnership did not undertake the section 453 investment strategy with a reasonable expectation that it would be profitable, on a pretax basis, for Colgate. We also conclude that the strategy was not pursued with a realistic expectation of realizing an economic profit for ABN. Petitioner's expert, Beder, concedes that the expected rate of return in an environment with a 50-percent probability on a rising rate and a 50-percent probability on a falling rate would only equal 2.3 percent. Moreover, as the excerpt from Pepe's testimony quoted above confirmed, the agreed allocation of transaction costs reflected the fact that ABN did not expect to derive any significant profit from the strategy. To the extent that interest on the Citicorp Notes may have exceeded the interest that could be earned on money market instruments, Kannex would have shared in this premium pro rata, but given the short holding period, the accumulation would not have been significant. Through the back-to-back hedge swaps that ABN arranged with Kannex and Merrill with respect to the LIBOR Notes, ABN relinquished the opportunity to gain from Kannex's interest in the LIBOR Notes.

Petitioner's experts correctly point out that it has become common in the capital markets to enter into one transaction only for the purpose of using it as the basis for a profitable swap opportunity. The fact that the swap effectively forecloses the possibility of gain from the underlying transaction does not mean that the transaction serves no profit objective. On the contrary, the underlying transaction is an indispensable component of the arbitrage scheme. Arbitrage, however, is not a plausible explanation for ABN's behavior in this instance. Based upon testimony of Merrill witnesses, petitioner emphatically maintains that ABN did not approach

Merrill with the proposal for the LIBOR Note hedge swap until shortly before the contingent payment sale. This was after the decision had been made, with Kannex's approval, to authorize the sale. If the partnership had authorized the section 453 investment strategy with the expectation that it would provide ABN with an arbitrage opportunity, presumably there would be evidence that ABN had planned, and attempted to arrange, its swap with Merrill beforehand.

More importantly, the terms of the back-to-back hedge swaps with respect to the LIBOR Notes are inconsistent with the arbitrage interpretation. In our Findings of Fact, we discussed at length the structural correspondence between these swaps and the hedge swaps between Merrill Capital, BFCE, and BOT, and we discussed the functional implications of that correspondence. Thus, although it appears that ABN could reasonably have expected to derive gain from these swaps, this gain represented value transferred, through the network of structured transactions growing out of the contingent payment sale, from the partnership to the banks, to Merrill Capital, and back to ABN and Kannex. The section 453 investment strategy was not designed to provide ABN with an opportunity for profitable LIBOR Note swaps. On the contrary, the swaps were calculated to compensate ABN in part for Kannex's share of the economic loss sustained by the partnership through the section 453 investment strategy.

Considering the high costs of the financial engineering it required and ABN's unwillingness to have Kannex share any of these costs or be exposed to any of the entrepreneurial risks it entailed, the section 453 investment strategy would not have been consistent with rational profit-motivated behavior in the absence of the expected tax benefits.

c. Hedging within the four Corners of the partnership

The theory of the LIBOR Note hedge was carefully developed in contemporaneous documents and argued in these proceedings. It forms the linchpin of petitioner's economic substance argument. It is, however, false. It is false even if we assume arguendo that there was as high a negative

correlation between the interest rate sensitivity of the LIBOR Notes and that of the Colgate debt as petitioner asserts, a proposition that respondent and her experts vigorously contest. To recognize why the theory is false it is necessary to grasp this central insight: Neither ABN nor Colgate needed a hedge inside the partnership for the Colgate debt because both were effectively fully hedged outside the partnership - ABN through swaps and Colgate by virtue of being the issuer of the debt. Employing an additional hedging instrument within the partnership was not only redundant, but also flatly inconsistent with the manner in which both principals were otherwise managing their interests in the partnership.

In his opening argument at trial, petitioner's counsel began his analysis of the case as follows:

> ACM, the partnership, is before the Court, and the tax treatment of its transactions is at the heart of the dispute. In many respects, however, the real party in interest is the Colgate-Palmolive Company and the impact of ACM's transactions from Colgate's vantage point is critical to understanding the substance of this case.

In justifying the partnership, petitioner argues that it was designed to perform functions integral and useful to Colgate's liability management strategy. On the other hand, petitioner argues that to evaluate whether the LIBOR Notes served a useful hedging function it is the effects "within the four corners of the partnership" that are relevant. The implication is that we should treat the position that Colgate held within the partnership through the instrumentality of Southampton as functionally unrelated to Colgate's liability management strategy: The utility of the LIBOR Notes is to be judged without regard to the primary purposes for which the partnership was created. It should be borne in mind that we are inquiring not whether a partnership should be treated as an entity or an aggregate for tax purposes or whether Southampton and ACM are entitled to be respected as separate legal entities, but whether there is any coherence to

petitioner's economic explanation for the existence of the partnership and Southampton's role in it. The shift in focus that petitioner proposes is simply a sophistical sleight of hand. With a little analysis, the absurdity of the implications of this proposition can be appreciated. In any event, we emphasize that while we make this analysis we nevertheless decline to unbundle the transaction in order to isolate one element that might have economic substance. Rather, we view the transaction as bundled and judge it in its entirety.

Colgate's position within the partnership was functionally analogous to an interest rate swap. This is the way contemporaneous documents of its treasury department analyzed Colgate's overall interest rate exposure, the way Colgate's accountants recommended that the investment in ACM be treated for financial reporting purposes, and the way Pohlschroeder described Colgate's intentions in designing ACM. The swap analogy is apt and useful for purposes of our economic substance analysis. Suppose that Colgate issues fixed-rate debt and, in order to reduce its exposure to interest rate movements, enters into a "plain vanilla" interest rate swap in which it receives fixed and pays floating interest. As a result, Colgate is hedged. Now suppose that Colgate modifies the swap agreement such that whenever interest rates fall or rise the fixed rate that it is entitled to receive on the asset leg of the swap will be lowered or raised by some specified proportion of the notional principal amount. The reason offered for this modification is that Colgate wants to limit its exposure to interest rates "within the four corners of the swap", by ensuring that both its rights and obligations under the swap will move in tandem. There is a major fallacy in this proposition. The only effect of modifying the swap in this way is to defeat its very purpose as a hedge against Colgate's exposure to the underlying debt issuance.

From Colgate's perspective, the partnership's investment in the LIBOR Notes had the same effect as the modification of the swap in this hypothetical. To the extent that changes in their value were inversely correlated with changes in the

value of the Colgate debt, the LIBOR Notes counteracted the hedging effect that Colgate was trying to achieve through its position in the partnership and thereby *increased* Colgate's exposure to interest rate risk.

Pohlschroeder's October 3, 1989, memorandum contains quantitative projections that show this clearly. Pohlschroeder analyzes the effects of a 200 basis point parallel shift in the Treasury yield curve on Colgate's financial position. The table presents his results.

Colgate's Financial Exposure to Partnership Portfolio
(Based on Pohlschroeder's Projections)
($ millions)

	Base Level	200 Basis Pt. Decline	Change
Long Bonds	(42.00)	(51.45)	(9.45)
Met Note	(98.00	(104.66)	(6.66)
Total liabilities	(140.00)	(156.11)	(16.11)
Partnership interest (15%)	21.00	23.42	2.42
Net liabilities	(119.00)	(132.69)	(13.69)
LIBOR Notes	60.00	48.99	(11.01)
Partnership interest (15%)	9.00	7.35	(1.65)
Net position	(110.00)	(125.34)	(15.34)

	200 Basis Pt. Rise	Change
Long Bonds	(34.88)	7.12
Met Note	(92.18)	5.82
Total liabilities	(127.06)	12.94
Partnership interest (15%)	19.06	(1.94)
Net liabilities	(108.00)	11.00
LIBOR Notes	69.90	9.90
Partnership interest (15%)	10.48	1.48
Net position	(97.52)	12.48

The parentheses in the table reflect that the Long Bonds and Met Note are liabilities for Colgate. Changes in the value of these liabilities are offset in part by changes in the value of Colgate's 15-percent interest in the partnership portfolio comprising these bonds and LIBOR Notes. When interest rates fall, Colgate's bonds appreciate, resulting in a $16.11 million decrease in the market value of Colgate's net worth.

This loss represents the opportunity cost to Colgate of being locked into a fixed rate liability that now exceeds the prevailing cost of capital in the market. By virtue of its proposed 15-percent ownership share in the partnership portfolio, Colgate realizes a gain that offsets this loss in part: The net effect on Colgate is a $13.69 million loss. But the partnership also holds LIBOR Notes, which decrease in value when interest rates fall. The effect of holding a 15-percent share of the LIBOR Notes through the partnership is to *magnify* the net effect of a fall in interest rates: If the partnership did not hold LIBOR Notes the market value of Colgate's net worth would decline by $13.69 million; the LIBOR Notes increase this loss to $15.34 million.

Now consider the effects of an increase in interest rates on Colgate's net worth. The Colgate bonds decrease in value by $12.94 million. The benefit to Colgate of having lower financing costs than the prevailing market rates is partially offset by Colgate's 15-percent share of the capital loss experienced by the partnership. But the net effect for Colgate is a gain. Colgate also benefits from the appreciation of the LIBOR Notes: If the partnership did not hold LIBOR Notes, the market value of Colgate's net worth would increase by $11 million; the LIBOR Notes increase Colgate's gain to $12.48 million. Thus, once again, the effect of the LIBOR Notes is to *magnify* Colgate's exposure to interest rates. From the perspective of Colgate's overall financial position, the LIBOR Notes do not function as a hedge at all.

There is a curious inconsistency in Pohlschroeder's memorandum between his discussion of how the partnership will serve Colgate's liability management objectives and his discussion of the function that the LIBOR Notes will perform. In the section entitled "Risk Management Within the Partnership", he calls attention to the importance of the partners' exposure to the interest rate volatility of the Colgate debt in the partnership portfolio, and states that the partnership will acquire LIBOR Notes "[t]o minimize the exposure to ABN and Colgate". "Based on the process of

negotiation, a hedge ratio is going to be negotiated with ABN which may not be a perfect hedge." This might be taken to imply that a perfect hedge would be desirable, if possible.

But Colgate would not really have wanted a perfect hedge. Indeed, in Pohlschroeder's view, for the foreseeable future, Colgate did not want to reduce its interest rate exposure within the partnership at all. On the contrary, consistent with his forecast of falling interest rates over the next 3 to 9 months, in a different section of the memorandum Pohlschroeder states that Colgate will use the flexibility of the partnership structure to *increase* its exposure within the partnership substantially above its pro rata share:

> One of the most important aspects of the partnership structure relates to the risk management of the interest rate risk as negotiated between Colgate and ABN. Colgate will attempt to negotiate a close to 50/50 sharing of the treasury risk.

To demonstrate how this arrangement would benefit the company, he examines how a 200 basis point decline in interest rates would affect the principals under different sharing ratios. He concludes:

> The more treasury risk is assumed by Colgate, i.e. 85/15 to 51/49, the better off Colgate is. The value of Colgate's share in the partnership is roughly $30 MM using the 85/15 example and increases to $36 MM if we were to assume 49% of the treasury risk and interest rates dropped by 200 b.p.

At some point in the future, Colgate might wish to reduce its exposure: "As an example, if we started with a 50/50 sharing ratio and see interest rates bottom out, in the future we could switch at the bottom of the interest rate cycle to a 100%/0% ratio."

The difficulty of reconciling the LIBOR Note hedge with Colgate's liability management strategy becomes more apparent in the light of events that unfolded over the next 11 months. In his memorandum, Pohlschroeder assumed that the

partnership would "establish a hedged capital structure with approximately $140 MM of Colgate debt and $60 MM of LIBOR Note hedge." The ratio of $140 million Colgate debt to $60 million LIBOR Notes originated in Merrill's first effort to integrate the CINS transaction into a liability management framework, the Partnership Transaction Summary dated July 28, 1989. Thereafter, all of Merrill's revisions of this document, its cash-flow projections and flip chart presentations to Colgate management through late October assumed that $200 million private placement notes would be sold for $140 million cash and $60 million LIBOR Notes. Around the time of the formation of ACM, however, it was decided that the partners could afford to do without a substantial amount of this internal hedge: $175 million private placement notes would be sold for $140 million cash and $35 million LIBOR Notes. No explanation was provided at trial, and none is to be found in the documentary evidence, of the reasons for the decision. But the effect was a reduction by 42 percent in the planned level of interest rate hedging protection and the retention of assets whose value would not vary with interest rates in a manner that undercut the effectiveness of Colgate's liability management strategy.[24]

At the time the LIBOR Notes were acquired, Colgate had no intention of using them to reduce Southampton's interest rate exposure. Its management of Southampton belies any such claim. Over the first 6 weeks after formation of ACM, Colgate increased Southampton's share of the Yield Component to 39.7 percent, more than double its original pro rata share and more than triple its pro rata share after the distribution of the BFCE Notes. In conformity with the original plan for a falling interest rate environment outlined by Pohlschroeder in his memorandum, it held Southampton's exposure at this level until September 1990.

---

[24] The change did not materially affect the size of the anticipated tax loss.

One might suppose that if the LIBOR Notes were acquired for their utility to Colgate as a hedge within the partnership it was because, even if Colgate might have desired leveraged exposure to treasury risk at the outset, at some point in the future when a rise in interest rates appeared imminent it would wish to minimize its exposure. Yet, before the LIBOR Notes were acquired, Colgate and Merrill had planned for the immediate disposal of 30 percent of them. The timing of the acquisition and disposition of the LIBOR Notes bore no relationship to Colgate's interest rate expectations.

If Colgate had intended to use the LIBOR Notes for protection against rising interest rates, they would not have been a cost-effective instrument for this purpose. Colgate appears to have had no reason to believe otherwise. In an undated document entitled "Risk Allocation Analysis" that seems to have been prepared for Colgate in late October or November, before the LIBOR Notes were acquired, Merrill estimated that a 200 basis point increase in interest rates would cause $35 million market value of LIBOR Notes to appreciate to $40.31 million. This appreciation of just over 15 percent would offset less than half of the devaluation of the Colgate bonds. Southampton's original 17.07 percent pro rata share of the gain on the LIBOR Notes would offset approximately $906,000 ($5.31 million x .1707) of its share of the loss. After distribution of the BFCE Notes, a 200 basis point increase in interest rates would have generated a $3.79 million offsetting gain on the remaining LIBOR Notes, of which Southampton would have been entitled to only $478,000, in proportion to its 12.6 percent post-distribution partnership interest. When Colgate would have reviewed the results of Merrill's analysis and planned with Merrill the distribution and sale of the BFCE Notes, it would have understood that the discounted present value of the transaction costs that it would bear in connection with the acquisition and sale of the LIBOR Notes would be in the vicinity of $2-3 million. The potential hedging benefits would properly be discounted for uncertainty. Let us assume, for example, that there was a weighted average probability of 50 percent that

interest rates would rise by an average of 200 basis points during the foreseeable future. A 50-percent probability is still clearly an overstatement, given the declining interest rate environment predicted in the implied forward rates that Beder estimated, in the market swap rates that Merrill used to price the LIBOR Notes, and in the Colgate treasury department's own forecasts. Nevertheless, even under this extreme assumption, the maximum hedging benefit that could be expected during the foreseeable future would have been less than 1/10 the expected cost (.5 x $478,000 ÷ $2.5 million).[25]

In December 1991, after the redemption of Kannex's interest, the partnership concluded that it no longer needed the BOT Notes. The explanation recited in the minutes of the twelfth partnership meeting is that since Colgate and Southampton now owned over 99 percent of the partnership, "the principal Partners' net economic exposure to the risk of interest rate fluctuations in the value of the Colgate debt was effectively minimal," and with their usefulness exhausted, so volatile an investment could not be justified. Heidtke's explanation at trial was as follows: "[A]t that point in time, the need for the - originally for the LIBOR notes as a hedge of the debt had basically gone away because now we owned all of the debt basically, so it was no longer outstanding, it was effectively retired".

It was reasonable for Colgate to be indifferent about exposure to the volatility of its own debt in the partnership portfolio at this time. Yet, it had always been the case that to the extent Colgate held its own debt through the partnership that debt was economically retired and there was no exposure to hedge. This was among the principal advantages of the liability management partnership identified in the Executive Summary dated October 9, 1989:

---

[25] The hedging benefit is maximal if it is realized immediately. The longer it takes for interest rates to rise, the lower the present value of this benefit.

> The Partnership also allows Colgate to effectively retire its debt, while leaving the debt outstanding for accounting purposes, * * * As Colgate bears a relatively greater share of the Treasury risk * * * with respect to its debt, it has economically retired an increasing percentage of such debt * * *

Petitioner's expert, Kenneth Singleton of Stanford University, makes the same point:

> [E]xposure to Colgate debt through Southampton would have fully hedged an equal amount of liabilities on Colgate's balance sheet * * * From this particular perspective, Colgate's investment in Southampton had an impact similar to the consolidation of the bonds owned by ACM onto Colgate's balance sheet * * *

If the LIBOR Notes were not necessary as a hedge for Colgate in December 1991, they had never been necessary.

It is true that the hedging effect of Colgate's investment in its own debt did not appear on Colgate's consolidated financial statements until ACM was actually consolidated for financial reporting purposes. All the same, the Colgate bonds were stated on the balance sheet at their historic cost and were not revalued to reflect changes in the market cost of capital. Yet, Colgate's investment in the partnership would be marked to market, in accordance with the convention for reporting swaps or other hedging activities. This asymmetrical accounting treatment could have been expected to add an insignificant volatility to the consolidated financial performance of the Colgate group. The question arises whether this undesirable accounting byproduct of Colgate's liability management strategy would have provided reasonable grounds for hedging within the partnership.

We do not think so. If the standard financial accounting treatment of hedging activities was a cause for concern warranting countervailing positions designed to eliminate the effects from the financial statements of the business,

businesses would routinely offset their own hedges and receive little or no net economic benefit from them. In July 1989, Colgate had entered into $300 million notional principal amount of interest rate swaps for liability management reasons similar to those that actuated its investment in ACM. That these swaps were also marked to market for financial reporting purposes evidently did not trouble Colgate, for it took no action to counteract their economic effects. Thus, a desire to stabilize the value of the ACM investment on its financial statements could not have provided a rational basis for the decision to hedge inside the partnership.

ABN never had any intention of using the LIBOR Notes as a hedge for Kannex's interest in the partnership. Instead, it hedged Kannex's exposure to the Colgate debt by means of swaps outside the partnership and, by separate swaps, eliminated the superfluous and deleterious effects of the volatile LIBOR Notes. However, that is not what the minutes of the third partnership meeting on December 12, 1989, suggest. According to the minutes, Taylor recommended that the partnership dispose of 20 percent of the LIBOR Notes because the planned exchange of some of the Long Bonds for new Colgate debt of shorter maturity would reduce the partners' interest rate exposure. "He further noted that such reduction would not adversely affect Kannex because of the Adjustment of sharing of Yield Component effected by the notice dated December 12, 1989, from Southampton-Hamilton Company", which lowered Kannex's share of the Yield Component. One would not gather from Taylor's explanation that, 2 weeks before the meeting, Kannex, ABN, and Merrill entered into the back-to-back hedge swaps that rendered the LIBOR Notes utterly ineffectual as a risk management instrument for Kannex, or that Kannex and ABN were also hedging Kannex's exposure to the Colgate debt so that Kannex would not be affected by Southampton's adjustments of the Yield Component.

The explanation for the decision to dispose of the BOT Notes provided in the minutes of the twelfth partnership meeting in December 1991 is likewise misleading. Pepe is reported to have said:

> [A]s Colgate and a subsidiary Southampton, owned 99.4% of the Partnership, the principal Partners' net economic exposure to the risk of interest rate fluctuations in the value of the Colgate debt was effectively minimal, and the Partnership need not maintain its position in the instruments purchased to hedge against such exposure.

Although there is no explicit assertion here that the partnership believed the LIBOR Notes to be necessary so long as Kannex was one of the principal partners, that is the implication.

Petitioner contends that Merrill and the Partnership Committee could honestly and reasonably have represented that the LIBOR Notes actually served as a hedge for Kannex's benefit. Petitioner denies that Merrill and Colgate knew of Kannex's swaps with ABN.

> [E]ven though Merrill entered into swaps with ABN relating to Kannex's share of the LIBOR notes owned by ACM, Merrill was not *specifically informed* of the Kannex/ABN swaps relating to the LIBOR notes. [Emphasis added.]
>
> Although Merrill may have suspected that Kannex and ABN had entered into similar swaps, there is no evidence that Merrill knew, in fact, that such a transaction had taken place. Consequently, there is nothing about Taylor's representation at the third Partnership meeting that is inaccurate or misleading.

It is true that there is no evidence in the record that ABN specifically apprised Merrill of its swaps with Kannex. But this misses the point. Petitioner seems to think that Merrill's understanding as to the utility of the LIBOR Notes would be

significantly affected by specific information or lack thereof that ABN was engaging in a swap with Kannex that mirrored the swap between ABN and Merrill. There was no doubt why ABN entered into its hedge swap with Merrill. The purpose and effect of that swap were to neutralize the impact of the LIBOR Notes on ABN's investment in the partnership. Nor was there any illusion that Kannex could pursue its own risk management strategy independent of the purposes of ABN. That knowledge alone would have been sufficient to enable Merrill to conclude that, in managing Kannex's participation, ABN had no use for a hedge within the partnership. There is also unequivocal evidence that Merrill was in fact aware of the activities ABN was conducting outside the partnership to hedge exposure to the Colgate debt on Kannex's behalf. Merrill consulted with ABN on revaluations of the Colgate debt, as an internal memorandum of the Merrill Swap Group explains, "[s]ince Kannex must actually trade Treasuries based upon the Base Treasury Yields".

The misleading explanations we find in the minutes were prepared long before the events they describe, during the planning of the section 453 investment strategy. Therefore, they raise the more fundamental issue of whether Merrill and Colgate could honestly and reasonably have planned to have ACM acquire the LIBOR Notes for ABN's use in managing the risks of Kannex's participation. The evidence is overwhelming that from the early stages in the planning of the liability management partnership at least Merrill, if not Colgate as well, expected that, as a matter of course, ABN would take steps to manage these risks independently.

To secure a partner for Colgate that would bear most of the interest rate risks of the liability management partnership's investments, Taylor approached the Financial Engineering Group of a major foreign commercial bank. As a rule, financial institutions like ABN do not expose themselves to interest rate risk; it is a common practice of such institutions to hedge their positions as promptly and fully as practicable. Taylor and his Swap Group knew this well

enough to offer structured transactions that eliminated interest rate risks to BOT, BFCE, and Sparekassen, as well as to all the banks that issued or purchased LIBOR Notes in connection with each of the section 453 partnerships that Merrill promoted. Taylor's Swap Group would not need to offer similar services to ABN. That would be the responsibility of den Baas and his Financial Engineering Group, whose regular business was to devise sophisticated structures for hedging interest rate and currency risks. As Kannex's financial adviser, den Baas's Group performed the function for which they had been recruited.

As a witness, Taylor was asked about his expectations concerning the manner in which ABN would handle the risks of Kannex's participation:

> Q: * * * Mr. Taylor, based on your experience with complicated transactions, why did you not expect or believe that ABN was hedging its risks with respect to ACM partnership?
>
> A: I didn't-did I say I didn't-I never said they wouldn't hedge.
>
> * * * * * * *
>
> Q: Okay. Did you believe that ABN would hedge its risks?
>
> A: Did I believe that they would hedge their risks? Yes, in some way, sure.
>
> Q: And hedge their risk with respect to their investment in ACM partnership?
>
> A: However they saw fit.

The expectation that ABN would manage the risks of Kannex's participation "however they saw fit" does not square with the notion that a hedge within the partnership was designed for the principals' mutual benefit. That expectation, however, was a cornerstone in Merrill's design for the liability management partnership. The concept of creating a

mechanism to separate treasury risk from credit risk and "allocating to each partner the risks that it is best able to bear" presupposed that the foreign partner would make use of the risk management capabilities in which it possessed a comparative advantage; it would have made no sense if the foreign partner were expected to rely upon risk management conducted at the partnership level. There was no attempt to make the LIBOR Note hedge into the kind of flexible and precise hedging instrument that Kannex would have required in order to provide Southampton with the Yield Component option it desired at an affordable cost. Taylor knew that this was unnecessary because ABN would not be relying on the LIBOR Notes in any case. Yordan testified that before the formation of ACM he asked Taylor why ABN would be willing for Kannex to bear the burden of the flexible interest rate risk allocation mechanism that Merrill contemplated. "[H]is answer was that they intended to - to enter into some hedge transactions to neutralize that risk". As Taylor expected, Southampton was able to negotiate for the Yield Component option at little or no cost. The partnership was successful because ABN exploited its comparative advantage in a manner consistent with rational economic behavior, and did not behave in the manner implied by the theory of the LIBOR Note hedge.

The LIBOR Notes served no useful risk management function for the partnership. Nor was there any genuine expectation on anyone's part that they would. The theory of the LIBOR Notes as a hedge "within the four corners of the partnership" was nothing other than an elaborate tax avoidance scheme that had no economic substance.

d. Interim use for idle cash

Petitioner explains the investment in the Citicorp Notes on November 3, 1989, in part by the need for an interim use for the partners' cash contributions during the indefinite period during which efforts were made to identify and acquire Colgate debt. This is supported by the account that Taylor gave of the sequence of events in his trial testimony:

> The partnership was funded on November 2nd. *From that date forward*, Colgate or Southampton-Hamilton was - was negotiating for the repurchase of a prior [sic-private] placement note from Met.
>
> Merrill Lynch was trying to identify, locate, and purchase Colgate long bonds, and ABN Bank was charged with identifying, locating, and purchasing Euro notes * * * so, * * * the cash needed to be invested and it was invested in these notes. [Emphasis added.]

The weight of the evidence indicates that the search for Colgate debt had begun long before the partnership was funded, and that by the beginning of November the timing of the partnership's purchase of the debt was largely within its control. Between December 4 and 8, 1989, ACM acquired the Met Note, Euro Notes, and Long Bonds in an aggregate principal amount of $135.9 million. Prior to ACM's formation, Merrill prepared a series of cash-flow projections with respect to the investment activities of a liability management partnership under various assumptions. In the six projections between August 8 and September 7, 1989, the amount of Colgate debt in the partnership portfolio is arbitrarily assumed to be $50 million. The actual target contemplated since July was $140 million. In the October 24, 1989, projection, the amount of Colgate debt is assumed to be $138.95 million. In the October 27, 1989, projection, it is assumed to be $134.96 million. The later numbers are not arbitrarily selected for purposes of illustration. They clearly purport to be estimates. Both the precision and the accuracy

of the estimates suggest strongly that by the time of the formation, at least several days before the Citicorp Notes were acquired, not only had Colgate debt been identified, but Merrill already had a very clear expectation of the prices.

In our Findings of Fact, we described in detail the pattern of studied hesitation and postponement calculated to hold up progress in consummating the purchases of Colgate debt. A brief summary will suffice. Weeks before his negotiations with Met Life on November 17, 1989, Pohlschroeder was ready, but unwilling, to negotiate. His reluctance to enter into discussion of specific terms before the appointed date was attributable at least in part to concern that the partnership's activities be conducted entirely offshore. Yet, the Partnership Committee authorized ABN Trust to proceed with the negotiations in an offshore location for that very reason, and evidently it made no efforts to do so. Final arrangements for the purchase of Long Bonds and Euro Notes in the marketplace were similarly delayed. In late October 1989, Pohlschroeder drafted standing orders which, on their face, purport to instruct Merrill not to make any purchases until the partnership had acquired the Citicorp Notes. Within 1 week after acquisition of the Citicorp Notes, the amount of cash that would be needed for purchases of the Colgate debt and the time it would be needed were definite enough that Merrill could press BOT and BFCE to conclude arrangements concerning the sale of the Citicorp Notes. The investment in the Citicorp Notes was not made to accommodate the timing of the acquisition of Colgate debt; rather, it was the reverse: The acquisition of the Colgate debt was timed so as to accommodate the requirements of the section 453 investment strategy.

If the timing of ACM's acquisition of Colgate debt was largely within the principals' control, and they were confident that negotiations could be concluded and sales closed within a short time, what the partnership needed for its temporary cash balances was a portfolio of short-term highly liquid investments. That need was not served by the decision to

acquire an undiversified portfolio consisting of Citicorp's unregistered 5-year notes. Nor can that need explain the decision to liquidate the portfolio by means of a complex structured transaction in which a substantial amount of the principal would be consumed by dealer fees.

ACM's conduct subsequent to the Citicorp Note purchase belies the claim that the use of the Citicorp Notes as a temporary store for partnership cash was economically sound. The Citicorp Note investment would not have met the criteria for management of temporary cash balances set forth in the partnership's Investment Guidelines, had they been in effect at the time. But the adoption of the Investment Guidelines 2 weeks later, like so many partnership decisions, appears to have been scheduled to accommodate the section 453 investment strategy. Once the Citicorp Notes had been sold, the partnership was at liberty to follow sound investment principles. The $140 million cash generated in the sale was invested in a diversified portfolio of commercial paper instruments maturing after 7 days. No liquidation costs were incurred to obtain the cash needed for settlement of the Colgate debt purchases. But financial assets that could be converted into cash without a sale and registered financial assets that could be traded on an exchange at relatively little transaction cost would not have satisfied Colgate's tax needs.

Petitioner argues that the choice of private placement notes allowed ACM to negotiate for a put option, "a valuable option it could not otherwise have obtained". The logic appears to be backwards. The partnership did not choose the Citicorp Notes because they offered a put. If ACM had invested in short-term money market instruments or otherwise in accordance with the criteria in its belated Investment Guidelines, it would not have needed a put option. The option was valuable because the partnership chose to invest all of its cash in 5-year notes of a single issuer that were not tradeable on an exchange.

e. The pattern of ostensibly market-driven decisions

Petitioner sums up the manner in which the partnership executed the section 453 investment strategy as follows:

> Although the evidence clearly indicates that the transactions ACM entered into were contemplated from the outset, it is equally plain from the record evidence that none of the ACM transactions was "pre-wired" or certain to occur. Moreover, it is clear that none of the parties was ever under any obligation to undertake any of the transactions: Ultimately market events and conditions dictated whether the transactions went forward and the terms on which they went forward.

The pattern of market-driven decisions that petitioner describes cannot be found in the record. On the contrary, the record reveals only a series of inconsistencies between the steps actually taken and the decisions that tax-independent considerations would have implied. There is no evidence that the occurrence or timing of any of these steps was a function of anything other than tax planning.

The documents that were drafted to explain the liability management partnership proposal for purposes of Colgate's internal review exhibit a scrupulous regard for the need to justify the proposal by reference to the relative costs of alternative structures. Petitioner presented expert opinion to the effect that ACM was a cost-effective vehicle for accomplishing Colgate's liability management objectives. By contrast, Pohlschroeder's account of how the decision was made to invest in the Citicorp Notes reveals a striking indifference to cost considerations. Petitioner points out, in support of its position that the consequences of ACM's transactions were not predetermined, that the partners' exposure to Citicorp's credit was "real, not theoretical". If the purchase of the Citicorp Notes confirms that market forces could have affected the economic outcomes for the partners, it also illustrates how little market considerations actually affected partnership decisions. Investing all $205 million

of the partners' capital in Citicorp Notes, most of which would be sold at market price rather than held until they could be put back to the issuer at par, did subject the partnership to risk. The Investment Guidelines reflect the judgment that such risk normally would not be justifiable. In order to explain the acquisition of the Citicorp Notes as an interim use for idle cash, preparations to acquire the Colgate debt were suspended. Over the short period that the partnership planned to hold the notes, any premium yield it may have earned from them could not have covered an appreciable amount of the costs that the partnership expected to incur upon their sale.

The acquisition of the LIBOR Notes, ostensibly to minimize the partners' exposure to a rise in interest rates, was planned and carried out at a time when Colgate expected interest rates would fall over the next several months, and accordingly desired leveraged exposure to interest rate risk within the partnership. Instead of initially setting Southampton's share of the Yield Component at the target level of approximately triple its pro rata share, Colgate caused Southampton to increase its share in two steps over a period of 6 weeks to provide part of the rationale for why the partnership no longer needed the hedging effect of the BFCE Notes, in accordance with scenarios developed several weeks beforehand. The acquisition of the LIBOR Notes was planned with the expectation that Kannex would not in fact have any net exposure to hedge, and the acquisition proceeded as planned even after ABN and Merrill had entered into an agreement that would offset their effect on ABN's interest altogether.

Each of the steps in the section 453 investment strategy was planned and arrangements commenced considerably in advance of execution.[26] Before the negotiations to form ACM, Merrill had

---

[26] Respondent's expert, Irving H. Plotkin, concluded that:

> In judging the economic rationality of the Partnership, it must be remembered that the complex financial transactions and the profits realized by the parties did not occur as a reaction to or consequence of random economic factors. Likewise, the very low

already begun negotiations to purchase the Citicorp Notes. Before their purchase, Merrill was negotiating for their disposition. By the time ACM acquired the LIBOR Notes, Merrill was arranging with Sparekassen the terms on which some of them would be sold. The contingent payment sale was scheduled to take place before the end of ACM's first taxable year in order to permit the partnership to spread its tax basis in the Citicorp Notes over 6 years instead of 5. The distribution and sale of the BFCE Notes was scheduled to occur before the end of Colgate's 1989 taxable year in order to offset Southampton's share of the contingent payment sale gain on Colgate's consolidated return. It was the understanding of the principals that Kannex would retire from the partnership by the fall of 1991 so that the LIBOR Notes could be sold in time for Colgate to carry back the taxable loss to its 1988 taxable year. No supervening market forces or other nontax considerations disrupted the scheduled execution of these steps. "'If we stood at the top of the world and looked down on this transaction', we would see events unfolding during the year[s] * * * about as they were contemplated when the plan was adopted." *Braddock Land Co. v. Commissioner*, 75 T.C. 324, 331- 332 (1980)(quoting *Mathews v. Commissioner*, 520 F.2d 323, 325 (5th Cir. 1975)).

But for the $100 million of tax losses it generated for Colgate, the section 453 investment strategy would not have been consistent with rational economic behavior. The section 453 investment strategy lacked economic substance. It served

---

(continued)

pretax rate of return suffered by Colgate was not the result of poorly chosen investments or of any unexpected adverse market conditions. Rather the transactions and the returns were the result of a carefully crafted and faithfully executed sequence of sophisticated and costly financial maneuvers that left little to chance or market opportunities. The score for the Partnership's actions was very detailed and the libretto even included the writing of the minutes of the Partnership meetings weeks before those meetings occurred. The actual Partnership transactions conformed to each of the seven steps choreographed in Merrill Lynch's September 1989 presentation to Colgate.

no useful nontax purpose. Accordingly, the pertinent adjustments made by respondent to ACM's reported items of income and loss are sustained.

To reflect the foregoing,

Decision will be entered under Rule 155.

APPENDIX C

I.R.C. § 453
(in pertinent part)

Installment method.

(a) General rule. – Except as otherwise provided in this section, income from an installment sale shall be taken into account for purposes of this title under the installment method.

(b) Installment sale defined. – For purposes of this section –

(1) In general. – The term "installment sale" means a disposition of property where at least 1 payment is to be received after the close of the taxable year in which the disposition occurs.

* * *

(c) Installment method defined. – For purposes of this section, the term "installment method" means a method under which the income recognized for any taxable year from a disposition is that proportion of the payments received in that year which the gross profit (realized or to be realized when payment is completed) bears to the total contract price.

* * *

(j) Regulations. –

(1) In general. – The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the provisions of this section.

(2) Selling price not readily ascertainable. – The regulations prescribed under paragraph (1) shall include regulations providing for ratable basis recovery in transactions where the gross profit or the total contract price (or both) cannot be readily ascertained.

I.R.C. § 1001
(in pertinent part)

Determination of amount of and recognition of gain or loss.

(a) Computation of gain or loss. – The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) Amount realized. – The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. In determining the amount realized –

(1) there shall not be taken into account any amount received as reimbursement for real property taxes which are treated under section 164(d) as imposed on the purchaser, and

(2) there shall be taken into account amounts representing real property taxes which are treated under section 164(d) as imposed on the taxpayer if such taxes are to be paid by the purchaser.

(c) Recognition of gain or loss. – Except as otherwise provided in this subtitle, the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized.

(d) Installment sales. – Nothing in this section shall be construed to prevent (in the case of property sold under contract providing for payment in installments) the taxation of that portion of any installment payment representing gain or profit in the year in which such payment is received.

Temp. Treas. Reg. § 15a.453-1(c)
(in pertinent part)

(3) Fixed period – (i) In general. When a stated maximum selling price cannot be determined as of the close of the taxable year in which the sale or other disposition occurs, but the maximum period over which payments may be received under the contingent sale price agreement is fixed, the taxpayer's basis (inclusive of selling expenses) shall be allocated to the taxable years in which payment may be received under the agreement in equal annual increments. In making the allocation it is not relevant whether the buyer is required to pay adequate stated interest. However, if the terms of the agreement incorporate an arithmetic component that is not identical for all taxable years, basis shall be allocated among the taxable years to accord with that component unless, taking into account all of the payment terms of the agreement, it is inappropriate to presume that payments under the contract are likely to accord with the variable component. If in any taxable year no payment is received or the amount of payment received (exclusive of interest) is less than the basis allocated to that taxable year, no loss shall be allowed unless the taxable year is the final payment year under the agreement or unless it is otherwise determined in accordance with the rules generally applicable to worthless debts that the future payment obligation under the agreement has become worthless. When no loss is allowed, the unrecovered portion of basis allocated to the taxable year shall be carried forward to the next succeeding taxable year. If application of the foregoing rules to a particular case would substantially and inappropriately defer or accelerate recovery of the taxpayer's basis, a special rule will apply. See paragraph (c)(7) of this section.

(ii) Examples. The following examples illustrate the rules for recovery of basis in a contingent payment sale in which stated maximum selling price cannot be determined but the period over which payments are to be received under the agreement is fixed. In each case, it is assumed that application of the described rules will not substantially and inappropriately defer or accelerate recovery of the taxpayer's basis.

Example (1). A sells Blackacre to B for 10 percent of Blackacre's gross yield for each of the next 5 years. A's basis in Blackacre is $5 million. Since the sales price is indefinite and the maximum selling price is not ascertainable from the terms of the contract, basis is recovered ratably over the period during which payment may be received under the contract. Thus, assuming A receives the payments (exclusive of interest) listed in the following table, A will report the following:

Year	Payment	Basis recovered	Gain attributable to the sale
1	$1,300,000	$1,000,000	$300,000
2	1,500,000	1,000,000	500,000
3	1,400,000	1,000,000	400,000
4	1,800,000	1,000,000	800,000
5	2,100,000	1,000,000	1,100,000

Example (2). The facts are the same as in example (1), except that the payment in year 1 is only $900,000. Since the installment payment is less than the amount of basis allocated to that year, the unrecovered basis, $100,000, is carried forward to year 2.

Year	Payment	Basis recovered	Gain attributable to the sale
1	$900,000	$900,000	———
2	1,500,000	1,000,000	$400,000
3	1,400,000	1,000,000	400,000
4	1,800,000	1,000,000	800,000
5	2,100,000	1,000,000	1,100,000

Example (3). C owns all of the stock of X corporation with a basis of $100,000 (inclusive of selling expenses). D purchases the X stock from C and agrees to make four payments computed in accordance with the following formula: 40% of the net profits of X in year 1, 30% in year 2, 20% in year 3, and 10% in year 4. Accordingly, C's basis is allocated as follows: $40,000 to year 1, $30,000 to year 2, $20,000 to year 3, and $10,000 to year 4.

Example (4). The facts are the same as in example (3), but the agreement also requires that D make fixed installment payments in accordance with the following schedule: no payment in year 1, $100,000 in year 2, $200,000 in year 3, $300,000 in year 4, and $400,000 in year 5. Thus, while it is reasonable to project that the contingent component of the payments will decrease each year, the fixed component of the payments will increase each year. Accordingly, C is required to allocate $20,000 of basis to each of the taxable years 1 through 5.

* * *

(7) Special rule to avoid substantial distortion – (i) In general. The normal basis recovery rules set forth in paragraph (c)(2) through (4) of this section may, with respect to a particular contingent payment sale, substantially and inappropriately defer or accelerate recovery of the taxpayer's basis.

(ii) Substantial and inappropriate deferral. The taxpayer may use an alternative method of basis recovery if the taxpayer is able to demonstrate prior to the due date of the return including extensions for the taxable year in which the first payment is received, that application of the normal basis recovery rule will substantially and inappropriately defer recovery of basis. To demonstrate that application of the normal basis recovery rule will substantially and inappropriately defer recovery of basis, the taxpayer must show (A) that the alternative method is a reasonable method of ratably recovering basis and, (B) that, under that method, it

is reasonable to conclude that over time the taxpayer likely will recover basis at a rate twice as fast as the rate at which basis would have been recovered under the otherwise applicable normal basis recovery rule. The taxpayer must receive a ruling from the Internal Revenue Service before using an alternative method of basis recovery described in paragraph (c)(7)(ii) of this section.

* * *

(iii) Substantial and inappropriate acceleration. Notwithstanding the other provisions of this paragraph, the Internal Revenue Service may find that the normal basis recovery rule will substantially and inappropriately accelerate recovery of basis. In such a case, the Service may require an alternate method of basis recovery, unless the taxpayer is able to demonstrate either (A) that the method of basis recovery required by the Service is not a reasonable method of ratable recovery, or (B) that it is not reasonable to conclude that the taxpayer over time is likely to recover basis at a rate twice as fast under the normally applicable basis recovery rule as the rate at which basis would be recovered under the method proposed by the Service. In making such demonstrations the taxpayer may rely in appropriate circumstances upon contemporaneous or immediate past relevant sales, profit, or other factual data subject to verification. In special circumstances a reasonable projection may be acceptable, but only with the consent of the Service, if the projection is based upon a specific event that has already occurred.